Inflation Report

June 2014*

* Submitted by the Technical Staff for a meeting of the Board of Directors on July 31, 2014.

Banco de la República
Bogotá, D. C., Colombia

ISSN - 2145-6536

The Inflation Targeting Strategy in Colombia

OBJECTIVES

Monetary policy in Colombia is based on inflation targeting, which is intended primarily to keep inflation low and to ensure stable growth in output near its long-term trend. Accordingly, the objectives of monetary policy combine the goal of price stability with maximum sustainable growth in output and employment. In this respect, monetary policy complies with the Constitution and contributes to the well-being of the Colombian population.

HORIZON AND IMPLEMENTATION

The Board of Directors of Banco de la República (BDBR of the Central Bank of Colombia) sets quantitative inflation targets for the current year and the next. BDBR policy initiatives are designed to meet each year's target and to provide for long-term inflation at around 3%. The annual change in the consumer price index (CPI) is the inflation measurement used.

THE DECISION-MAKING PROCESS

Monetary-policy decisions are based on an analysis of the current state of the economy and its prospects for the future, as well as on the assessment of the forecast for inflation in light of the targets. If the assessment suggests with enough certainty that inflation will deviate from its target under current monetary-policy conditions and that said deviation would not be due to temporary shocks, the BDBR modifies its policy stance. For the most part, this is done by changing the benchmark interest rate (charged by Banco de la República on short-term liquidity operations).

COMMUNICATION AND TRANSPARENCY

Decisions on monetary policy are announced after meetings of the Board of Directors. This is done through a press release posted immediately on the Bank's website (www.banrep.gov.co).

Inflation reports are published quarterly and lend transparency to the Board's decisions. They also contribute to a better understanding of monetary policy and help to enhance its credibility. Specifically, these reports: i) allow the public know how the Board of Directors and the Technical Governor of the Bank view recent and anticipated changes in inflation and its short and mid-term determinants; ii) explain the implications of those determinants for monetary-policy management within the scope of inflation targeting; iii) describe the context and analysis justifying monetary-policy decisions made during the quarter; and iv) provide information that helps agents in the economy to form their own expectations about future developments with respect to inflation and growth in output.

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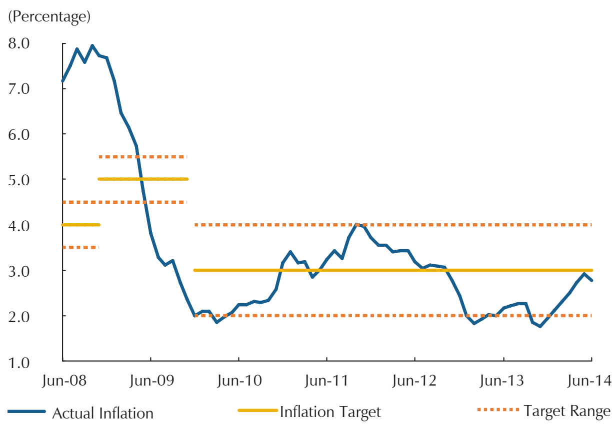
Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República

Annual inflation increased in the first five months of the year and converged towards the 3% target slightly faster than expected. It declined somewhat in June to 2.79% (Chart A). A significant part of this movement is explained by the spike in prices for food and regulated items, given reversal of the favorable conditions that pushed the prices of these two baskets to unusually low levels in 2013. The average of the core inflation measures increased to a lesser degree, largely because of the behavior in tradable goods. As a reflection of this, inflation expectations increased and are now near or slightly above 3% for horizons of one year or more.

The forecasts for December suggest prices for food and regulated items will increase at a higher annual rate. The annual changes in the rest of the CPI basket would reflect relative stability. This being the case, annual inflation would end up slightly above 3%.

As for economic activity, the Colombian economy grew at an annual rate of 6.4% in the first quarter of 2014, which is higher than the rate on record for the final quarter of 2013 (5.3%) and more than was expected by the market and by the technical staff of Banco de la República. This positive outcome is due to the momentum in consumption and construction of civil works and buildings, which performed better than had been forecast. The new figures on household spending indicate it will continue to grow at a good pace. This is consistent with a persistently declining unemployment rate, good growth in retail sales, an increase in consumer confidence to favorable levels, and a growth rate in consumer lending that brought its slowdown to a halt. As for investment, this item is expected to grow at a high rate, but less so than during the first quarter.

The total growth in lending has increased due to the added momentum in commercial loans and mortgages. This situation is coupled with real interest rates on loans at levels that bolster spending.

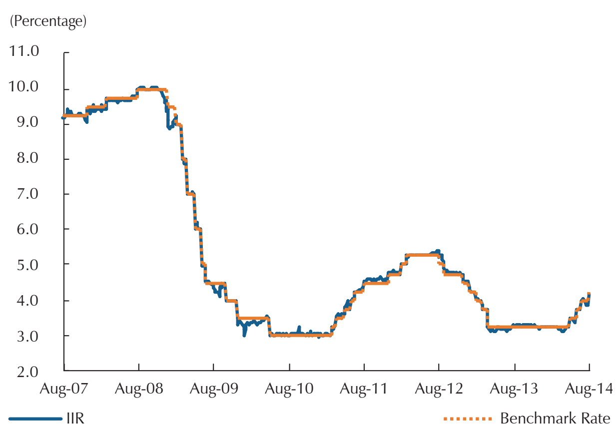
On the external front, average growth for Colombia's major trading partners has been weaker than was forecast earlier this year, given the sharp drop in GDP in the United States during the first quarter and less growth in some countries of the region. However, the new data suggest external demand will be more dynamic in the coming quarters.

Liquidity levels in the United States remain less expansive and foreign interest rates are still low, although higher than the average observed in 2013. Risk premiums in several emerging economies continue to be low, financial assets in local currency have gained in value, and some of their currencies have appreciated against the dollar.

This being the case, the Bank's technical team estimates a growth range for the second quarter of 2014 between 3.6% and 5.0%, with 4.3% being the most likely figure. The forecast for growth in 2014 as a whole was revised upwards and is now within a range of 4.2% to 5.8%, with 5.0% as the most feasible figure.

In summary, the growth of aggregate demand in Colombia remains strong and has led gradually to the use of nearly full productive capacity. Domestic spending is expected to continue to expand at a dynamic pace, accompanied by a recovery in external demand. The build-up in inflation halted briefly in June, but the short-term forecasts suggest it will be slightly above 3% by December. Inflation expectations have hovered around 3% or slightly higher. All this is occurring in an environment where growth in lending has increased and real interest rates on loans are at levels that are driving spending.

Graph B
Banco de la República Benchmark Interest Rate and Interbank Interest Rate (IIR)
(2007-2014)[a/]



a/ The figures pertain to the data for working days. The last figure is for August 4, 2014.
Sources: Financial Superintendence of Colombia and Banco de la República

After evaluating the risk balance, the Board of Directors of Banco de la República decided to raise the benchmark interest rate by 25 basis points at each of its meetings in May, June and July. As a result, it was increased from 3.50% to 4.25 % (Figure B). The Board felt that macroeconomic stability and the convergence of inflation towards the long-term target support these benchmark interest rate hikes.

Moreover, in June, it was decided the amount of international reserves purchased during the third quarter would be increased so as to accumulate up to US $2 billion between July and September.

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Inflation Report

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I. External Situation and Balance of Payments

In the second quarter of 2014, global economic activity expanded faster compared to the previous three months, thanks largely to the strong recovery in the United States.

However, the emerging economies, especially in Latin America, exhibited a slowdown in productive activity.

During the first three months of the year, Colombia's terms of trade remained relatively high, because of high international oil prices. No major changes in this indicator are anticipated during the rest of the year.

As for 2014, the current account deficit is expected to widen as a result of the trade balance.

A. THE INTERNATIONAL SITUATION

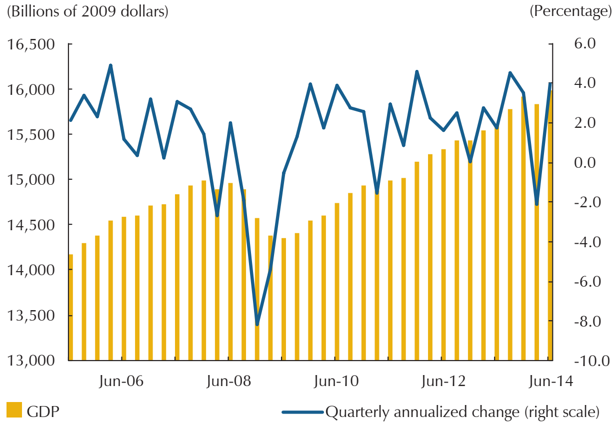
1. Productive Activity

Global economic activity expanded at a faster rate during the second quarter of 2014 than in the previous three months, due largely to a sharp acceleration in the United States following poor results in the first quarter of the year. The euro area would have continued on its slow path to recovery during this period. As for the emerging economies, a slight increase was observed in Chinese growth, while in Latin America, with few exceptions, the momentum in productive activity continued to slow down, given the weakening domestic demand and less foreign trade.

The second quarter saw strong recovery in the United States, in contrast to the slowdown in the emerging economies, especially in Latin America.

In the case of the United States, its gross domestic product (GDP) rose at a quarterly annualized (q.a.) rate of 4.0% during the second quarter of 2014 (Figure 1), which represents a significant recovery from the poor outcome observed in the first three months of the year (-2.1% q.a.). This good per-

Graph 1
Real GDP in the United States



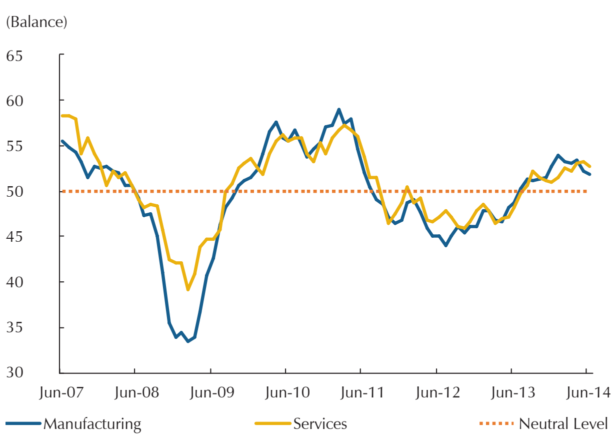
Source: Bureau of Economic Analysis.

formance is explained mainly by the build-up in household consumption, which went from 1.2% q.a. growth in the first quarter to 2.5% q.a. growth in the following quarter, thanks to higher spending on durable goods. Similarly, increases were seen in government spending and the various investment categories, especially residential investment. This contrasts with the weakness exhibited by these components during the first three months of the year.

As for the job market in the United States, the unemployment rate continued on a downward trend during the first half of the year, reaching the lowest level of the past five years in June (6.1%). This is the result of increased job creation during the period, with an average of approximately 230,000 new jobs per month. Even so, although other job market indicators still show improvements, they are a long way from the levels witnessed before the crisis. For example, the average duration of unemployment and underemployment by the hour remains high and suggests the job market has yet to recover completely.

Economic activity in the euro area continued to recover at a modest pace during the first quarter of 2014, when GDP expanded at a quarterly annualized rate of 0.8%. The figures at hand for the second half of the year suggest similar performance during that period. The figure at June kept the indicators of sentiment in the manufacturing sectors in expansive terrain (Figure 2), as did business and consumer confidence, which was still at favorable levels. Meanwhile, indicators such as those for retail sales and industrial production show moderate growth, similar to that of previous months.

Graph 2
Purchasing Managers Index (PMI)

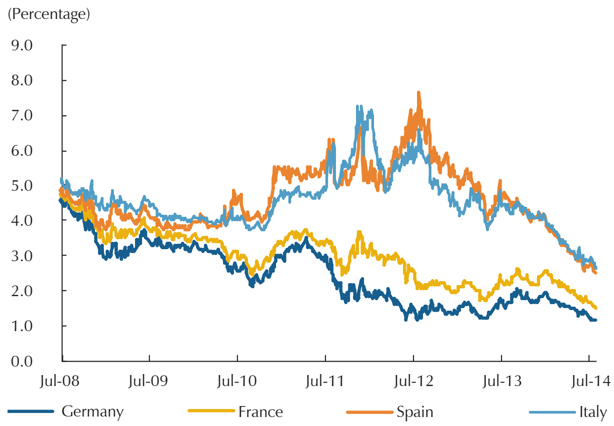


Source: Bloomberg

As for the different countries, the performance of productive activity remains mixed. On the one hand, the German economy is still the most robust in the region, led by buoyant domestic demand. Similarly, GDP growth in Spain would have accelerated during the second quarter, although still at a modest pace. In contrast, the picture is less favorable for countries such as France, Italy and Portugal, whose indicators suggest their economic activity remains stagnant or is declining.

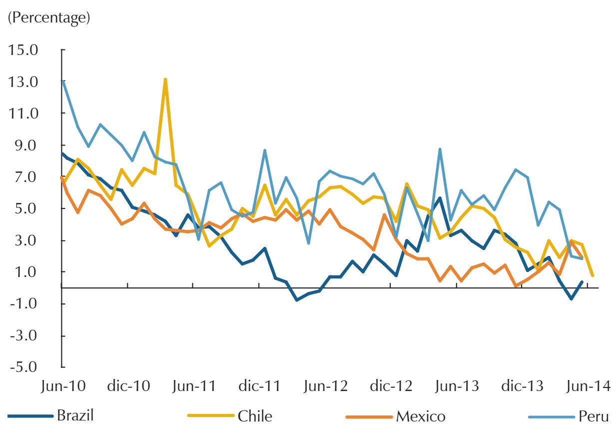
One favorable sign in Europe has been the reduction in the interest rate spreads on government bonds between the countries at the core and those

Graph 3
Interest Rates on 10-year Government Bonds for Several European Economies



Source: Bloomberg

Graph 4
Annual Growth in Monthly Economic Activity Indexes for Several Latin American Economies



Source: Datastream

on the periphery (Figure 3). This allowed for a drop in domestic financing costs, thereby reducing some of the pressure on the fiscal accounts of these countries, which should help to reduce financial fragmentation of the region.

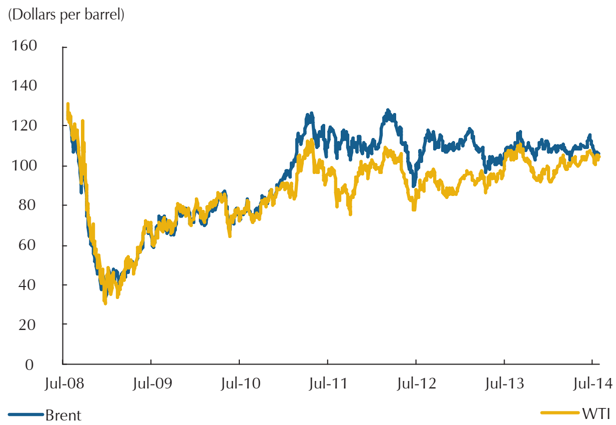
In the case of the emerging economies, their performance in the second quarter was mixed. On the one hand, the annual growth in China's GDP accelerated slightly, from 7.4% to 7.5%, in line with the target announced by the government for all of 2014. This is due, in part, to the adoption of a series monetary and fiscal policies designed to stimulate specific sectors of the economy (e.g. low-income housing and railway projects). Private consumption also performed well. However, there are still major threats to the country's financial stability, given the sharp rise in prices for real estate and loans, especially those granted by shadow banks.

Furthermore, the monthly production indexes in Latin America continued to grow more slowly than in previous years (Figure 4). Export growth was still weak, due to the decline in terms of trade and less external demand. Internal conditions also have deteriorated somewhat, and several supply shocks had an impact on agricultural production and mining. Argentina, Brazil and Venezuela are the countries with more mediocre performance. The case of Chile is noteworthy as well; its annual growth fell to just 2.0% in the first three months of the year. This slowdown might have been more pronounced in the second quarter, when the country would have grown 0.8%, according to the information at June for the leading indicator of economic activity.

2. Commodity Prices, Inflation and Monetary Policy

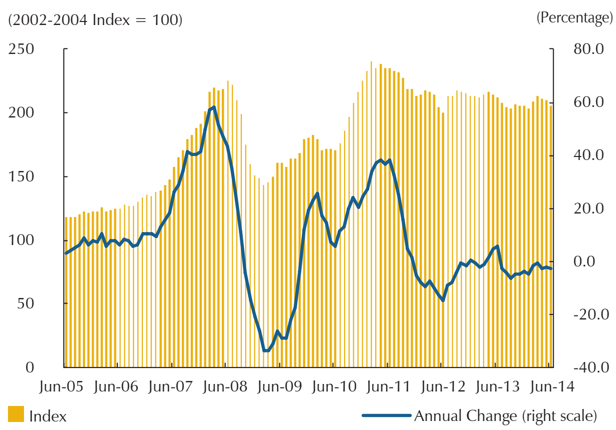
In terms of international prices for Colombia's commodity exports, oil prices showed an increase in volatility in recent months (Figure 5), due to escalating geopolitical tension in the Middle East. Even so, the average price so far this year remained at levels similar to those observed in 2013, but higher than was anticipated for 2014 in the last edition of the Inflation Report.

Graph 5
International Oil Prices (Brent and WTI)



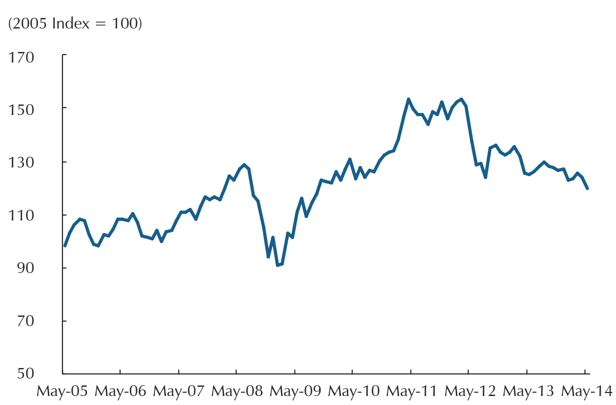
Source: Datastream.

Graph 6
International Food Prices



Source: Food and Agriculture Organization of the United Nations

Graph 7
Index of Colombian Terms of Trade



Note: This chart is based on the commerce method.
Source: Banco de la República

International coffee prices stabilized during the second quarter at the high levels posted three months ago. This is because the global supply continues to be affected by the adverse weather conditions Brazil faced at the beginning of year and outbreaks of plant rust in Central America. In the case of nickel, prices during the second quarter remained at levels above the average in 2013, reflecting prospects for a lower supply of this metal due to the geopolitical conflict in Ukraine and the restrictions imposed on nickel exports by the Indonesian government.

International food prices declined somewhat in the second quarter, keeping the annual change in the food price index of the United Nations Food and Agriculture Organization (FAO) in negative terrain (Figure 6). This is largely the result of a better outlook for the global production of cereals, given the increase in supply in the United States, India and the European Union.

In this context, the country's terms of trade, according to the commerce method,[1] fell slightly during the early months of the year and continued to be less than in 2011-2012. Even so, they maintained a favorable level in light of their historical average (Graph 7).

As for inflation in the major developed economies, performance has been mixed. On the one hand, measurements of total and core inflation in the euro area continued to decline during the second quarter and remained below 1%. In contrast, records of these indicators in the United States showed higher levels compared to three months ago. However, it is important to point out that the personal consumption expenditure defla-

1 Measuring terms of trade by the commerce method is based on the export and import records kept by official sources (DIAN-DANE). Pursuant to international recommendations (concerning the volatility of the series, standardization of unit values, etc.) implicit prices are calculated for each tariff item and subsequently weighted in a chained Paasche-type price index

The Fed continued to taper its monthly purchases of financial assets, while the ECB adopted additional monetary stimulus measures. The central banks in the emerging economies maintained an expansive monetary policy.

tor, which is the measure that the Federal Reserve of the United States (Fed) monitors the most, is still below the long-term target, despite trending upward. Meanwhile, prices in Japan posted their biggest annual increase in more than a decade, due to the consumption tax hike that took effect as of April.

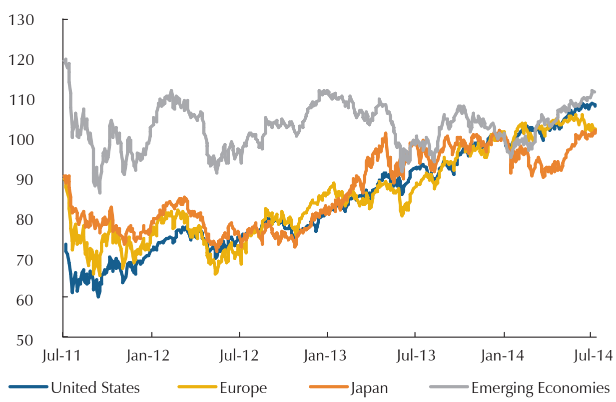
With respect to monetary policy, the Fed continued to gradually taper its monthly purchases of financial assets, as announced late last year. The benchmark rate was kept low and is not expected to be raised until the second half of 2015. Meanwhile, deflationary fears and weak economic recovery in the euro area prompted the European Central Bank (ECB) to adopt stimulus measures. The most important of these include a reduction in the policy interest rate, the implementation of negative deposit rates, and an expansion in liquidity through long-term refinancing operations (LTRO), this time with the proviso that the financial systems make loans to the non-financial private sector.

In the emerging economies, the outlook for inflation remained mixed. Several spikes in inflation were observed in Latin America, associated partly with the depreciation of its currencies in the early months of the year and adverse weather shocks. In fact, the central banks of Chile, Mexico and Peru have reduced their benchmark rates, given the temporary nature of these increases and the fact that economic activity is weak. In contrast, the annual change in consumer prices remained low in China, Korea and Taiwan, and trended downward in India and Indonesia. Given this context, the central banks of these economies have made no changes in their monetary policy.

3. Financial Markets

Graph 8
Global Stock Indexes

(January 2014 Index = 100)

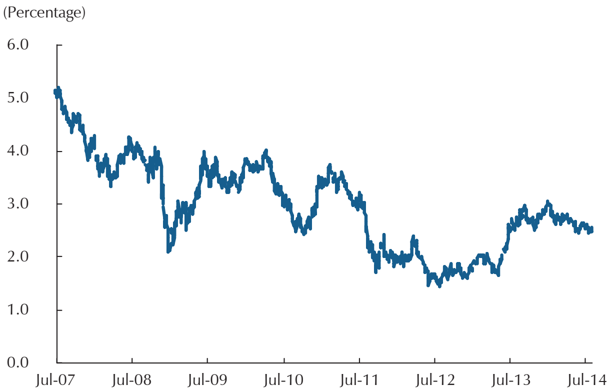


Source: Bloomberg

Unlike the situation observed in the second half of 2013, when the onset of discussions on removal of the Fed's monetary stimulus measures heightened the volatility in financial markets and generated fears about economic and financial stability in some emerging countries, global financial markets have performed favorably so far this year. This was evident in most of the emerging countries where capital inflows increased, risk premiums declined and stock indexes gain value (Figure 8).

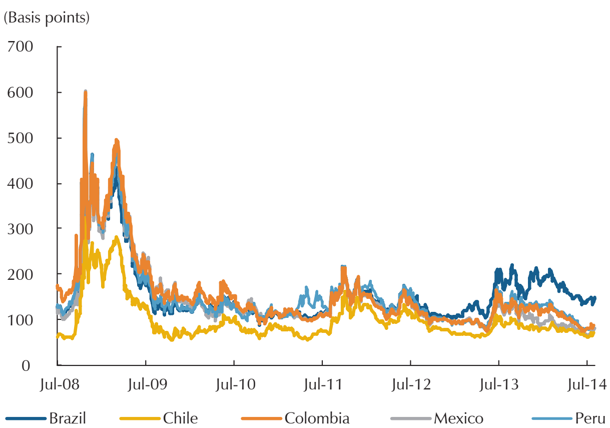
The only exception has been the euro area, which has seen an increase in the volatility of its finan-

Graph 9
Interest on Ten-year US Treasuries



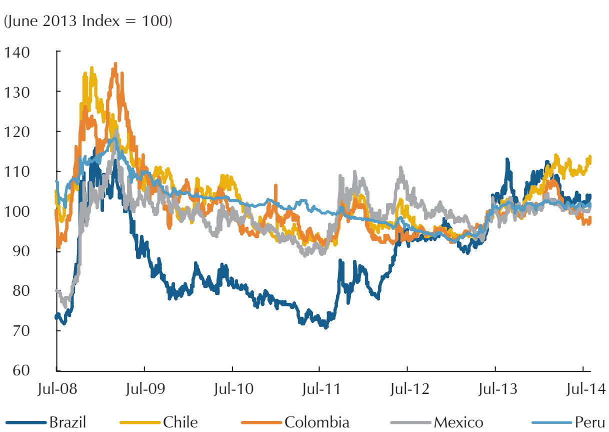
Source: Bloomberg

Graph 10
Five-year Credit Default Swaps (CDS) for Several Latin American Countries



Source: Bloomberg

Graph 11
Exchange Rate Indexes for Several Latin American Countries



Source: Bloomberg

cial markets as well as the devaluation of its stock indexes, given the prospect of an escalation in the geopolitical conflict between Ukraine and Russia and the possibility that it might affect EU recovery (Figure 8).

In the United States, interest rates on long-term securities stayed relatively stable during the first half of the year, despite the Fed's tapering. As a result, their levels are still below those observed in December 2013 (Figure 9).

In the case of Latin America, there were no major changes in risk premiums during the second half of the year. Credit default swaps at five years showed very little volatility during this period (Figure 10). The results for exchange rates were mixed with respect to the levels witnessed last year. The strongest appreciation in the region was in Colombia, continuing the trend that began in March of this year. Similarly, although to a lesser extent, the Brazilian real and the Mexican peso also gained strength. In contrast the Chilean peso continued to weaken and depreciated by about 15% compared to the previous year (Figure 11).

4. Forecasts by Banco de la República's Technical Staff

The economic growth forecasts for Colombia's trading partners are revised downward in this report compared to the forecasts in the March edition. This issue reflects the first-quarter contraction in the United States and the weakness observed in the emerging economies, particularly in Latin America. Consequently, growth for Colombia's major trading partners (weighted according to non-traditional trade) is expected to be 2.5% this year. The forecast three months ago was 2.8% (Table 1).

By country, the poor performance in the United States during the first quarter of the year would affect the growth on record for the year as a

Table 1
Growth Forecasts for Major Trading Partners

Growth forecasts for trading partners	2013	Forecasts for 2014			Forecasts for 2015		
		Scenario			Scenario		
		Minimum expected	Central	Maximum expected	Minimum expected	Central	Maximum expected
Main partners							
USA	2.2	1.3	1.9	2.5	2.0	3.0	4.0
Euro zone	(0.4)	0.5	1.0	1.5	0.6	1.4	1.8
Venezuela	1.3	(3.0)	(1.0)	1.0	(1.0)	1.0	3.0
Ecuador	4.5	3.0	4.0	5.0	3.0	4.0	5.0
China	7.7	6.8	7.3	7.7	6.4	7.0	7.6
Other partners							
Brazil	2.5	0.5	1.5	2.3	1.0	1.8	2.5
Peru	5.8	4.5	5.0	5.5	4.5	5.5	6.5
Mexico	1.1	2.0	2.8	3.5	2.7	3.7	4.7
Chile	4.1	2.5	3.0	3.5	3.0	4.0	5.0
Total trading partners (non-traditional trade-weighted)	3.0	1.6	2.5	3.5	2.1	3.2	4.3
Developed countries[a/]	1.3		1.8			2.4	
Emerging and developing countries[a/]	4.7		4.6			5.2	
Total worldwide[a/]	3.2		3.4			4.0	

a/ IMF forecasts at July 2014
Source: Banco de la República calculations

whole. However, the considerable momentum witnessed in the second quarter is expected to continue during the remainder of the year, propelled largely by increased strength of the various components of domestic demand. This being the case, the trend towards recovery in the US job market is expected to continue and, as such, growth for all of 2014 is forecast at 1.9%. Furthermore, the recovery in productive activity should continue during 2015; accordingly, growth that year would be 3.0%.

In terms of monetary policy, earlier forecasts assume the Fed's financial asset buying program would culminate early in the fourth quarter and exert no further significant effects on long-term interest rates. The Fed is not expected to begin to raise its benchmark rate until the second half of 2015.

The scenario for the euro area in 2014 has not changed significantly from what was described in the March edition of the Inflation Report. The productive economy is expected to continue to recover slowly, fueled by domestic demand, mainly in Germany, and emergence from the recession in several economies on the periphery. Likewise, the contractive effects of the fiscal adjustment would be less than in 2013. The monetary measures adopted recently should have a positive impact on lending and on the pro-

During 2014, the Chinese economy would grow at a rate very close to the target set by the government. Most of the Latin American economies are expected to experience a slowdown compared to 2013.

ductive sector, particularly as of next year. In fact, the possibility of new stimulus measures adopted by the ECB to reduce deflationary risks in the region and to stimulate growth cannot be ruled out.

As for the emerging economies, growth in China is expected to stabilize during the second half of the year, meaning the country would grow throughout 2014 at a rate very close to the target set by the government. This would confirm the reduced momentum in domestic demand (mainly for investment) and external demand, which would be offset only in part by the fiscal and monetary policies focused on certain sectors of the economy. The result would be lower growth rates for the country than in the past. The slowdown in productive activity in China would have major impact on external demand worldwide and could bring downward pressure to bear on certain international commodity prices.

During the rest of 2014, some Latin American economies such as Chile and Peru would continue to be affected by low metal prices and a series of supply shocks that have impinged adversely on mining production. In Chile, business expectations have declined sharply, casting doubt on future performance. The moderation in domestic demand, largely because of less investment and household consumption, also had an effect on the economic momentum in these countries. Other economies in the region, such as Venezuela and Argentina, still have structural problems that would continue to slow their growth this year and the next. The Brazilian economy would continue to weaken amid a context of less consumer and business confidence.

The slowdown in China is expected to continue during 2014, given the efforts of the authorities to rebalance the country's growth from investment towards consumption. The Latin American economies should see some recovery.

With respect to commodity prices, the deceleration in China and the retooling of its productive apparatus towards cleaner energy sources would continue to lower international prices for coal. In contrast, the conflicts in Syria, Iraq and Libya would keep oil prices high. Accordingly, the average price forecast for all of 2014 has increased from US $ 105 to $ 109 per barrel, compared to the previous edition of this report. Coffee prices would continue to rise, given difficult weather conditions and the presence of blight in some producing countries. Nickel is also expected to see price hikes due to geopolitical uncertainty and the persistence of restrictions on nickel exports in Indonesia (Table 2).

The geopolitical conflicts in the Middle East would keep oil prices high.

As in previous quarters, the central scenario continues to show risks to the downside that are far from negligible. This time, they are associated mainly

Table 2
Reference Price Forecasts for the Commodities Exported by Colombia

Major products	2013	Forecasts for 2014 Scenario			Forecasts for 2015 Scenario		
		Minimum forecast	Central	Maximum forecast	Minimum forecast	Central	Maximum forecast
Colombian coffee (*ex dock*; dollars per pound)	1.48	1.60	1.90	2.10	1.20	1.70	2.30
Brent crude (dollars per barrel)	108.7	106	109	112	96	104	112
Coal (dollars per ton)	88.0	70	75	80	70	78	86
Nickel – London exchange (dollars per ton)	15.091	13.779	15.747	17.716	14.435	17.059	19.684
Gold[a/] (dollars per troy ounce)	1.411	1.320	1.280	1.200	1.300	1.100	1.000

a/ This is assumed to be a safe haven commodity, as the price of gold increases when there is more uncertainty (a pessimistic scenario).
Source: Bloomberg; Banco de la República calculations

with the performance of the emerging economies, especially China, where there are persistent fears of excessive growth in lending and a real estate bubble, which would pose a major threat to the country's financial stability if it were to burst. A sharp drop in China's growth would affect global economic activity through less external demand and also through a drop in international commodity prices. This last impact would be stronger in the economies that exports products of this type.

Similarly, a setback in the recovery of the euro area cannot be ruled out, given the frailty of the financial system and the job markets. An additional risk in this scenario comes from an intensification of the geopolitical situation between Russia and Ukraine, which could threaten the growth of Europe and other economies that are linked to the region financially and through trade.

Finally, another risk scenario is one where normalization of monetary political in the United States occurs sooner than the market expects, due to the emergence of increased inflationary pressures in that economy. This could diminish the liquidity in international financial markets, raising the cost of funding and generating a reversal of capital flows to emerging economies. Similarly, if a strong market correction occurs, the confidence of market agents could be affected.

B. BALANCE OF PAYMENTS

Growth in the deficit during the first quarter of the year was associated with the trade balance in goods, which was negative throughout that period.

Colombia's balance of payments for the first quarter of 2014 showed a current account deficit equal to 4.6% of GDP (US $ 4,015 m). This is higher than the deficit during the same period last year (3.6% of GDP, US $ 3,232 m). The widening of the deficit was associated mostly with the trade balance in goods, which was negative for the first quarter of the year, following a surplus the year before. This is explained by negative export growth rates, *The result for the trade balance was offset partially by a slight reduction in net outflows of factor income, due to fewer profits transferred abroad.*

due to lower sale prices for mining products and coffee, coupled with less volume in some sectors such as petroleum by-products.[2] Imports, on the other hand, increased by over 4% annually, bolstered by the momentum in domestic demand and uncommon fuel purchases.[3] The results for the trade balance were offset partially by a slight reduction in net outflows of factor income, due to fewer profits transferred abroad.

In terms of funding, the deficit in the external balance was supported during the first quarter of the year by US $ 4,419 m in net income in the capital and financial account (5.1% of GDP). This amounts to US $ 1,381 m more than the year before. Net foreign investment was the primary source of these resources, both direct and portfolio investment. However, foreign direct investment (FDI) was down 6.6% annually, mirroring the decline in investments in the oil sector during the first three months of the year. Added to this is the increase in flows of Colombian investment abroad, which meant less value in terms of net revenue from foreign direct investment in Colombia. As for portfolio investment, the government's sale of bonds on the foreign market, coupled with increased inflows to the TES market, favored portfolio income for the public sector, which was offset partially by the higher acquisition of portfolio assets by the private sector during the same period.

The trade balance is expected to remain negative during the second quarter of 2014.[4] Specifically, the available figures on foreign trade in goods for April-May 2014 indicate there is still a trade deficit. In fact, total exports in dollars declined during that period by 4.7%, on average , compared to the previous year (Figure 12), affected by fewer exports of gold,[5] refined products, vehicles and other non-traditional products. The value of imports

The current account deficit during the first quarter of the year was supported by US $ 4,419 m in net income in the capital and financial account (5.1% of GDP).

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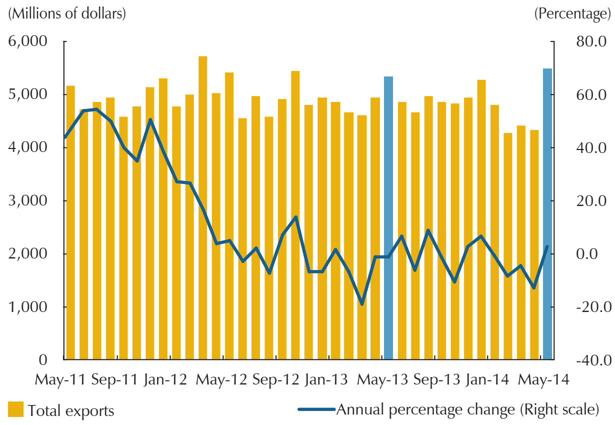
2 The reduction in sales of petroleum by-products is related to scheduled closure of the refinery in Cartagena (Reficar), by stages. This is being done to make way for the start-up of the new refinery, which also will occur in stages. The process began in early March and will continue until the first quarter of next year, when the refinery is expected to be back in operation with twice the production capacity.

3 The foregoing is in response to the aforementioned supply shock from Reficar.

4 However, this outcome would be less, as a percentage of GDP, than during the first quarter, given the effect of a lower exchange rate in the calculation of GDP in dollars for that period.

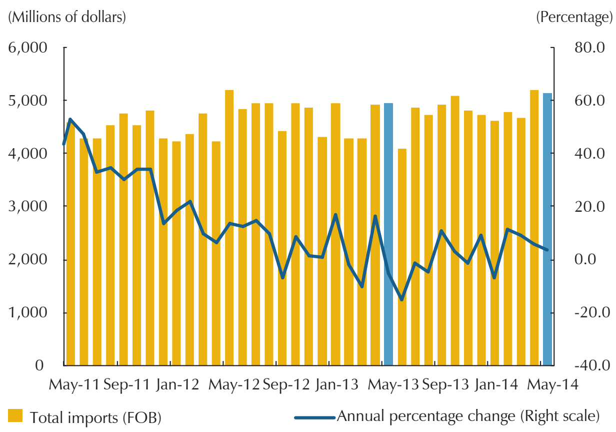
5 One reason for the sharp drop in gold exports was because several of the companies that mine and export gold transferred to the free-trade-zone regime. As a result, some exports of gold are recorded in these areas, thereby reducing the registration of those DANE reports for the national customs territory (NCT). When gold exports from free-trade zones are included in the calculation, the decline in total exports is less than that what is on record when only the NCT is considered.

Graph 12
Total Exports
(Monthly)



Source: DANE; Banco de la República calculations

Graph 13
Total Imports FOB
(Monthly)



Source: DANE; Banco de la República calculations

FOB[6] rose 4.9% in annual terms (Graph 13) (See the shaded section on pg. XX.).

The negative trade balance could be offset partly by lower outflows of factor income, as some of the problems in the mining-energy sector persist in terms of developing productive operations, which could mean fewer profits remitted from this sector. Net income from current transfers would be similar to the values posted in previous quarters, bolstered by some recovery in remittances from workers in the United States and the euro area.

The available figures on capital flows from the exchange balance[7] show a reduced influx of FDI resources so far this year, particularly for sectors other than oil, while inflows for financial or portfolio investment by the private sector are up compared to a year ago, fueled by the restructuring of JP Morgan's government bond indexes for emerging markets. Additionally, there are the external resources registered for the public sector in the second quarter of the year due to $2 billion in bonds marketed by Ecopetrol.

The forecast for the balance of payments in 2014 implies a possible current account deficit between 3.8% and 4.2% of GDP, with a higher central forecast than the actual amount in 2013 (3.3% of GDP) (Table 3). This is consistent with a slight downturn in the international situation which, despite the boost from the recovery in the advanced economies —mainly thanks to better prospects for the United States as of the second quarter and the end of the recession in the euro area—, would be overshadowed by a visible slowdown in the growth of emerging economies, especially in the countries of the region. This would lead to a slight reduction in external

6 Unlike the measurement of the balance of payments, which takes into account imports FOB (free on board), the GDP calculation based on the national accounts considers imports CIF (cost, insurance and freight), which include the value of freight and insurance. The average total value of the latter, in dollars, came to US $ 5,439 m in April and May 2014, which amounts to an annual increase of 5.1%

7 Although the capital flows in the foreign exchange balance do not pertain exactly to those in the balance of payments, since the former refer to the entry and outflow of foreign exchange, they do offer some idea of the movements of the balance of payments.

Table 3
Balance of Payments
Annual Flows (Millions of dollars)

	2010	2011	2012 (pr.)	2013 (pr.)	2014 (fcst.)
Current Account (A + B + C)	**(8,666)**	**(9,713)**	**(11,592)**	**(12,408)**	**(16,165)**
Share of GDP	(3.0)	(2.9)	(3.1)	(3.3)	(4.0)
A. Goods and services	**(1,887)**	**950**	**(1,055)**	**(2,841)**	**(6,223)**
B. Primary income (factor income)	**(11,227)**	**(15,497)**	**(15,116)**	**(14,140)**	**(14,541)**
C. Secondary income (current transfers)	**4,448**	**4,834**	**4,579**	**4,572**	**4,599**
Financial Account (A + B + C + D)	**(8,921)**	**(8,844)**	**(11,374)**	**(11,879)**	**(16,531)**
Share of GDP	(3.1)	(2.6)	(3.1)	(3.1)	(4.1)
A. Direct investment (ii - i)	**(947)**	**(6,228)**	**(15,726)**	**(8,702)**	**(11,217)**
i. Foreign in Colombia (FDI)	6,430	14,648	15,119	16,354	15,252
ii. Colombian abroad	5,483	8,420	(606)	7,652	4,035
B. Other long-term flows (loans, bonds)	**(6,970)**	**(6,120)**	**(1,805)**	**(9,927)**	**(5,248)**
C. Short-term (TES and domestic market shares, other investments)	**(4,147)**	**(238)**	**751**	**(196)**	**(3,862)**
D. Reserve assets	**3,142**	**3,742**	**5,406**	**6,946**	**3,796**
Errors and omissions	**(255)**	**869**	**218**	**530**	**(366)**

(p.): preliminary.
(fcst.): forecast.
Note: The results presented, starting in this edition, follow the recommendations proposed by the IMF in the sixth edition of the Balance of Payments Manual. For additional information and methodological changes, go to http://www.banrep.gov.co/balanza-pagos
Source: Banco de la República.

demand, particularly demand for Colombia's non-traditional exports. This scenario would be accompanied by a recovery in prices for some of the country's leading exports such as oil, coffee and ferronickel, partly offsetting the performance displayed by Colombian exports so far this year.

In this context, it is estimated that the value of exports in 2014 will be similar to what it was last year, due to the decline in sales of non-traditional products, offset by a slight increase in those associated with the main export products. This performance assumes a recovery in export value during the second half of the year, thanks to larger volumes of oil, coal and ferronickel exports, in addition to higher average prices.

The prospects for domestic demand support sustained growth throughout the remainder of the year. Added to this is the increased need for imports of refined products[8] and the reactivation of purchases of capital goods fueled by the major infrastructure projects announced for the country.

8 It is important to point out that the trade balance would continue to be affected by the temporary closure of Reficar during the remainder of the year.

The deficit forecast for the current account would be financed mainly with FDI resources; however, these inflows are expected to be less during 2014 as a whole than in 2013.

Outlays of factor income and net income from transfers are estimated at values similar to those observed in 2013. To begin with, the remittance of profits would remain stable throughout 2014, thanks to the recovery anticipated in the mining-sector during the second half of the year. Moreover, resources from workers' remittances could be boosted by the economic recovery in the United States and by Spain's emergence from recession, but would contrast with a decline in remittances from other destinations, such as Venezuela, which have been falling since the beginning of the year.

The deficit forecast for the current account would be financed mainly with FDI resources; however, these inflows are expected to be less during 2014 as a whole than in 2013. This is because problems with implementing investment projects in the hydrocarbon industry would affect the level of FDI in this sector during the year. This situation would be accompanied by reduced flows of foreign direct investment from Colombians abroad, compared to the previous year, which would bring an increase in net direct investment in the country. Added to these resources are the inflows for portfolio investment, which are expected to surpass the levels on record for 2013. They would be driven particularly by major sales of government bonds and the arrival of these flows to the local public debt market, following JP Morgan's announcements[9] in favor of Colombian government bonds. These inflows would be offset, in part, by the increase in the formation of assets by the private sector. Finally, it is important to note that the forecast for the balance of payments reflects a change in gross international reserves consistent with the intervention announced by Banco de la República[10] and the financial returns associated with these reserves.

The inflows for portfolio investment, which are expected to surpass the levels on record for 2013, would be driven particularly by major sales of government bonds.

In 2015, external financing terms are expected to remain favorable for the Colombian economy, which would enable the country to have enough resources to sustain a current account deficit similar to the one forecast for 2014. However, the improvement in external demand anticipated for next year, coupled with success in overcoming the supply problems that are affecting performance in certain sectors this year (oil and petroleum by-products), suggest there could be a slight correction in the country's external balance during the years ahead.

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9 In March, JP Morgan announced it would include five new Colombian government bond references (TES) in two of its indexes; namely GBI-EM Global Diversified and GBI-EM Global, as of May 30.

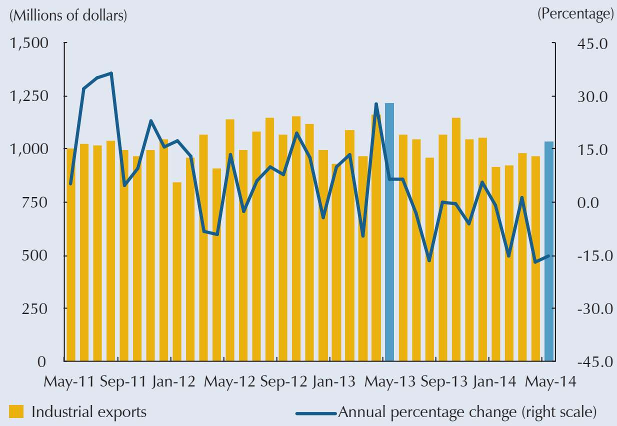
10 Considers announced purchases of up to $ 2 billion in foreign exchange between July and September 2014.

Total exports posted a decline of 4.6% during the first quarter of 2014 compared to the same period the year before. This was attributed to fewer foreign sales of mining and industrial products, which were down 6.1% and 5.4% annually, in that order. The negative results for the first group were associated largely with the drop in prices for ferronickel and gold, which affected the value of these exports. The situation with gold was reinforced by the sharp reduction in volumes shipped. Industrial exports were affected by fewer foreign sales of vehicles and refined products, which fell 13% and 56%, respectively. These declines were reflected in sales to all destinations except Ecuador. On the other hand, products of agricultural origin were favored by higher production volumes. However, in the case of coffee, the rise in volume was offset by lower export prices. Imports during this period rose 4.2% annually, bolstered particularly by foreign purchases of intermediate goods, especially fuel (See Section B in this chapter).

Exports in dollars during April-May 2014 continued to post negative annual growth rates due to a drop in foreign sales of mining and industrial products. Exports of mining origin fell 3.0% annually during that period, on average, while industrial exports did so by 16.0% (Chart A). This last figure is associated with the performance of ferronickel sales, which experienced sharp reductions in export volumes that have yet to be offset by higher international prices for this product. Moreover, May witnessed a continued decline exports of gold, given lower international prices compared to the previous year and the effect of exports from free-trade zones (See Section B in this chapter). In contrast, oil and coal exports rose during that two-month period, on average, thanks to an increase in the quantities sold abroad. Industrial exports[1] between April and May declined to all destinations, except the United States. Trade with Venezuela was affected the most during this period (-33.5% annually) (Figure B). The negative trend in the growth of these exports continues to be associated with fewer sale of vehicles and refined products, coupled with poor performance during this period by products such as apparel, textiles and meat.

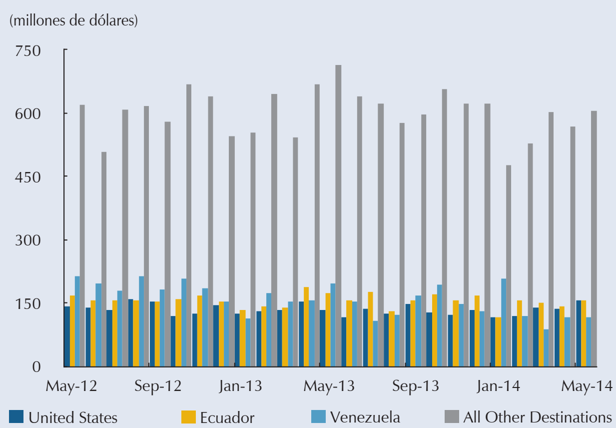
1 These exports do not include oil or its by-products, coal, ferronickel, gold, coffee, bananas or flowers, and represent 20% of total exports during that period. Industrial exports account for 96% of this group.

Graph A
Industrial and Other Exports[a/]
(Monthly)



a/ Excluding petroleum by-products, coal, ferronickel, gold, coffee, bananas and flowers. Includes other mining and agricultural products.
Source: DANE, Banco de la República calculations

Graph B
Non-commodity Industrial Exports to the United States, Ecuador, Venezuela and All Other Destinations[a/]
(Monthly)

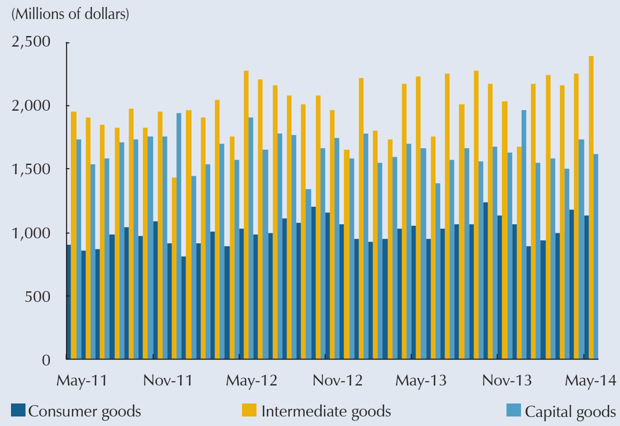


a/ Does not take into account coffee, petroleum by-products, ferronickel or gold.
Source: DANE, Banco de la República calculations

Exports of agricultural origin were up by 14.4% annually during April-May 2014, due to the sizeable increase in export volume for coffee, bananas and flowers, coupled with the recovery coffee prices.

FOB imports in dollars rose 4.9% annually during this period, on average. This was due primarily to more imports of consumer goods, which increased at an average annual rate of 10.2%, reflecting the good performance of imports of durables and non-durables (11.4% and 9.0%, respectively). Added to this is the annual rise of 5.7% in purchases of intermediate goods, bolstered particularly by a higher demand of fuel and raw materials for industry. Imports of capital goods continued to decline during this two-month period, posting a drop of 0.7% as a result of fewer purchases of capital goods for agriculture and industry (Graph C).

Graph C
Imports by Product Type (FOB)
(Monthly)



Source: DANE, Banco de la República calculations

Box 1
PROFITS OF FOREIGN COMPANIES IN COLOMBIA:
SECTOR MOMENTUM AND PROSPECTS

Aarón Garavito
Celina Gaitán
Adrián Martínez*

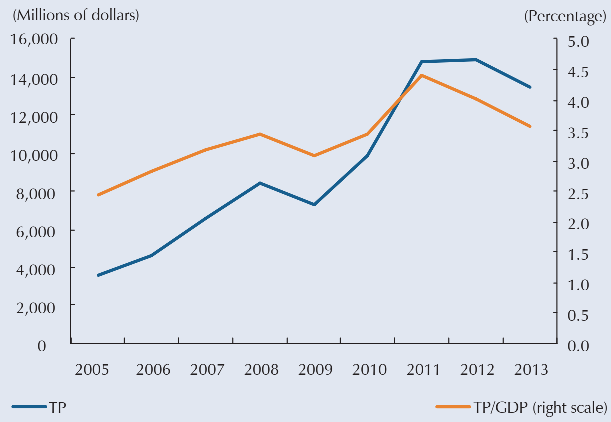
1. Profits and Current Account Deficit

In recent years, the country has supplemented its shortage of savings with different sources of external funding, with foreign direct investment (FDI) being one of the most important. Capital flows of this type are characterized by greater stability and by the potential benefits FDI can generate for the economy, such as technology transfer, capital formation and chaining between sectors, among others.

Funding through FDI and good performance by the sectors that capture these resources have been related to increased profits for companies with foreign capital. This indicator rose significantly in the last ten years, from US$4,590 m (2.82% of GDP) in 2006 to US$ 13,432 m (3.56% of GDP) in 2013 (Graph B1.1). Accordingly, this sector increased its share of external outflows and has been a source of important pressure on the current deficit (Graph B1.2).

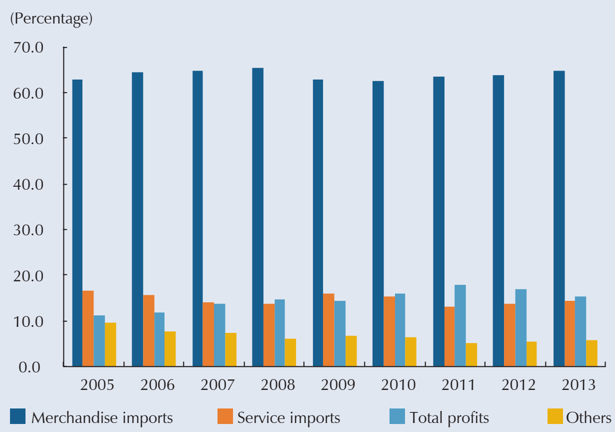
This phenomenon is not exclusive to Colombia and has been observed in other countries in the region. The Economic Commission for Latin America and the Caribbean (ECLAC, 2013)[1] says the profits of firms in Latin America and the Caribbean with foreign capital quintupled between 2002 and 2011, due to an increase in the supply of FDI and its added profitability. According to the same report, the latter was associated with higher international prices for commodities and economic growth in the region's major economies, facts that favored firms with foreign capital investment that are dedicated to the extraction and export of natural resources, as well as firms focused on the sale of goods and services to the domestic market.

Graph R1.1
Total Profits



Source: Banco de la República

Graph R1.2
Composition of Current Account Outlays in the Balance of Payments



Source: Banco de la República

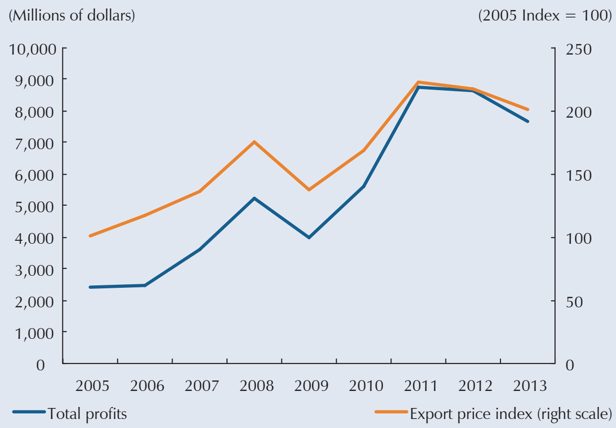
2. Sector Development

The growth in earnings reported by foreign firms in Colombia has been bolstered by the financial results of oil and mining companies, followed by those involved in transport and communications, industry, public utilities and commerce. The profitability of tapping natural resources has been favored by the sharp rise in international prices for these commodities and the amounts being produced. Indeed, between 2005 and 2013, export prices for oil and coal increased 101% and 84%, respectively (Graph B1.3). In the other sectors mentio-

* The authors are, respectively, a specialized professional and a professional with the Programming and Inflation Department, and a professional with the Technical and Economic Information Department. The opinions expressed herein and any errors or omissions imply no responsibility on the part of Banco de la República or its Board of Directors.

1 Cepal (2013), "La inversión extranjera directa en América Latina y el Caribe, 2012", informe anual.

Graph R1.3
Total Profits and Export Prices in the Mining and Petroleum Sectors



Source: Banco de la República

ned, there has been a consolidation of foreign investors, who have benefited particularly from the growth in domestic demand.

The profitability implicit[2] in mining and oil extraction has been close to 16% in the last four years. This is above the average for the other sectors (10%). ECLAC (2013) says that foreign investment in the extraction of raw materials has obtained a return of more than 10% in some countries, such as Bolivia, Chile, Colombia, Peru and the Dominican Republic, as opposed to an average yield of 7.8% for the region as a whole.

Profits from the mining and oil sectors have a different impact on the current account deficit than those from other activities. In the first case, income and, therefore, profits originate mostly with exports, mitigating the impact on the current account. In turn, the other sectors (commerce, public utilities, financial services, communications and a portion of industry) are engaged mainly in the domestic market and do not register a significant amount of foreign income to cushion the profits reported in the balance of payments.

Finally, it is important to point out that some of the total profits recorded as outlays in the current account are reinvested in the country as a component of FDI. Sectors other than mining and oil use a higher proportion of their earnings (three quarters, equivalent to US$3,200 m) to finance their domestic operations. Of the total earnings reinvested in the country, 73% is attributed specifically to the manufacturing industry, transportation and communications, public utilities, and financial services.

3. Prospects

Considering the international price outlook for mining and energy products, these markets would be experiencing the end of the cycle of high prices observed in recent years, which favored the arrival of FDI in the Colombian case. With a likely reduction in international prices for products such as oil and coal, it is estimated that FDI flows to these sectors could decline. This, in turn, would imply less factor income associated with these investments; it would also be related to a drop in foreign income derived from these exports which, in net, could mean additional pressure on the current account deficit.

The increase in FDI for other sectors poses an additional challenge to the deficit in the medium and long term. The arrival of resources in sectors other than mining, such as transportation, the financial sector, commerce and telecommunications, which relay largely on the domestic market, could mean a future increase in current spending if the growing momentum in domestic demand continues, since these sectors contribute the least to the direct generation of foreign exchange that mitigates the effect of remittance of profits. In this respect, large-scale infrastructure and telecommunications projects, as well as the current boost from strong domestic demand, will continue to enhance the relative importance of these sectors, which could result in an increased outflow of resources through the remittance of dividends and profits.

An international environment favorable to investment in emerging countries also meant an important increase in FDI in Colombia, not only through added equity investments, but also via the momentum in reinvestment of profits, bolstered by low rates in international markets and uncertainty in the advanced economies. This situation could be reversed by prospects for a recovery in international markets and normalization of monetary policy in the United States, reducing capital flows to the emerging countries and, in this sense, slowing the growth in returns on foreign capital.

Finally, although FDI in Colombia has grown, the extent of the build-up in assets by Colombians abroad has improved as well. This is important to note and could offset part of the pressure on the current account through income from profits on these investments in the years ahead.

2 This is the ratio between the outflows generated by the profits that are registered in the balance of payments and the capital stock of each sector that comprises the international investment position (IIP) under the concept of foreign direct investment (FDI).

II. Domestic Growth: current situation and short-term outlook

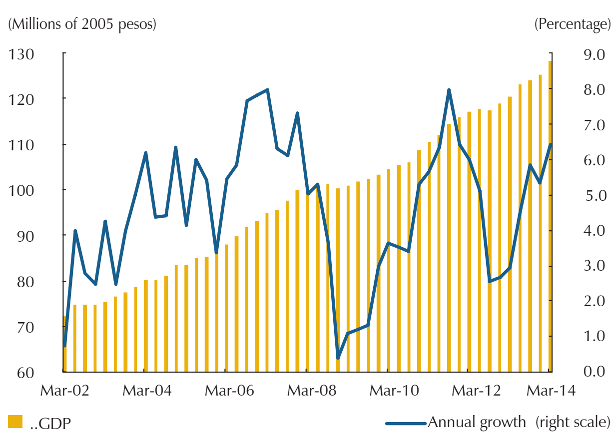
In the first quarter of 2014, the Colombian economy grew 6,4% in annual terms, exceeding the figure for the fourth quarter of 2013 and the forecast range outlined in the previous edition of the *Inflation Report*. This increase is due mainly to the momentum in domestic demand, from both consumption and investment.

During the second quarter of 2014, GDP would have continued to expand at a good rate, although less than in the first three months of the year. Private consumption and investment still contribute actively to the performance of domestic demand.

As for the different branches of economic activity, the performance in sectors such as construction, social, personal and community services, and financial services was particularly important.

A. GDP IN THE FIRST QUARTER OF 2014

Graph14
Gross Domestic Product
(Seasonally Adjusted)



Source: DANE, Banco de la República calculations

Colombia's productive apparatus expanded at an annual rate of 6.4% during the first three months of 2014 (Figure 14), according to the National Bureau of Statistics (DANE). This exceeded the growth on record for the last quarter of 2013 (5.3%). It also was more than the market expected and above the forecast range presented in the previous edition of this report (between 4.2% and 5.4%, with 4.8% as the most likely figure). The quarterly growth was 2.3%. It also worth highlighting that DANE revised growth upward for all of 2013, from 4.3% to 4.7%.

It should be noted that the effect of more working days during this period would have influenced the series published by DANE. According to the estimates by the technical staff at the Bank of the Republic, this effect would have added 50 basis points (bp) to GDP growth. This suggests the Colombian economy would have expanded at an annual rate of 5.9% in the first quarter, discounting this calendar effect.

The success in economic growth during this period was due to acceleration in the expansion in domestic demand, which grew 8.7% annually. This is the highest rate in the last nine quarters. The momentum in this sector was fueled largely by the performance of investment, although domestic consumption also grew at a good rate. As for the first case, construction of civil works is to be highlighted; as for the second, final government consumption (Table 4).

Table 4
Real Annual GDP Growth by Type of Spending

	2013				2013	2014	Contributions to Growth
	I Qtr..	II Qtr..	III Qtr..	IV Qtr..	Full Year	I Qtr..	I Qtr.. 2014
Total consumption	**3.8**	**4.5**	**4.6**	**4.5**	**4.4**	**5.6**	**4.5**
Household consumption	3.6	4.4	4.5	4.4	4.2	5.1	3.4
Non-durable goods	2.5	4.7	4.3	5.0	4.1	5.6	1.2
Semi-durable goods	3.7	7.0	6.4	6.6	5.9	6.8	0.4
Durable goods	5.3	4.2	9.8	(3.2)	3.8	6.2	0.2
Services	4.0	4.1	4.1	4.5	4.2	4.3	1.5
End government consumption	5.6	5.7	5.9	6.1	5.8	7.5	1.2
Gross capital formation	**0.8**	**1.8**	**10.7**	**7.4**	**5.1**	**16.9**	**4.7**
Gross fixed capital formation	4.5	0.8	11.7	7.7	6.1	14.6	4.1
Agriculture, forestry, hunting and fishing	(1.4)	(6.1)	(10.0)	(13.9)	(7.9)	3.7	0.0
Machinery and equipment	2.5	3.0	1.6	4.3	2.9	12.8	1.2
Transport equipment	(14.4)	(14.6)	1.5	9.4	(4.9)	3.6	0.1
Construction and buildings	12.2	12.5	31.8	(3.7)	12.0	8.3	0.6
Civil works	10.2	(0.2)	19.7	20.8	11.9	25.4	2.2
Services	4.0	(2.6)	12.9	3.3	4.2	6.0	0.0
Domestic demand	**3.1**	**4.0**	**6.3**	**5.4**	**4.7**	**8.7**	**9.5**
Total exports	**0.7**	**10.3**	**2.3**	**8.5**	**5.4**	**6.9**	**1.2**
Total imports	**1.7**	**4.2**	**4.8**	**7.4**	**4.5**	**16.3**	**(4.3)**
GDP	**2.9**	**4.6**	**5.8**	**5.3**	**4.7**	**6.4**	**6.4**

Source: DANE; Banco de la República calculations

Private consumption registered good growth, surpassing the rate posted towards the end of last year and the average since 2001 (4.0%). A breakdown of this item by components shows increases in expenditure for non-durable, semi-durable and durable goods. Consumption of services maintained an important degree of momentum, similar to its historical average (4.2%).

There was important momentum in investment, and all its components expanded at rates above those reported in the final quarter of 2013.

Most of the items comprising investment expanded at rates higher than those reported by DANE for the final quarter of 2013. The largest contribution in this respect came from construction of civil works, a category that grew at an annual rate of 25.4%. Construction of buildings registered important growth as well, surpassing the rate for the rest of the economy, although less than the figure for 2013. The performance of investment in machinery and equipment was another high point, having increased 12.8% compared to the same period a year earlier. The only component that slowed down compared to the fourth quarter was spending on transport equipment, although it did grow at positive rates and above those observed on average for 2013 as a whole.

The results for foreign trade were mixed. On the one hand, annual export growth slowed somewhat with respect to the fourth quarter of 2013, mainly because of the various supply shocks that affected the mining sector throughout the quarter and the temporary shutdown of the Cartagena refinery (Reficar, see Chapter I). As for imports, DANE reported added expansion thanks to foreign purchases of refined petroleum products (due, in part, to the temporary closure of Reficar), building materials and capital goods.

On the side of supply, the sectors that contributed the most to growth of the Colombian economy were construction, financial services, and social, community and personal services, in that order (Table 5). Most activities showed a higher annual growth rate during the first three months of 2014 than in the fourth quarter of 2013, apart from mining and electricity, gas and water. Industrial activity stands out, having accelerated significantly compared to the previous quarter.

Construction was the best performing sector, both in terms of civil works (24.8%) and buildings (7.9%). The performance of the former was associated mainly with the good momentum registered by the category comprised of highways, streets and bridges, which rose 31.9% and contributed 12.7 percentage points (pp) to the total variation. Larger payments from national and territorial agencies to construct, maintain, repair and upgrade roads were responsible for this outcome, having risen 30.5% and 32.9%, respectively. In turn, the performance of building construction was the result of increased execution during the stages of the construction process that have more added value, plus continuation of the government's social housing programs and the stimulus provided by the subsidies to interest rates on home mortgages for middle-income buyers.

Construction, financial services and social, community and personal services were the sectors that contributed the most to growth of the Colombian economy.

As for the financial sector, although the pace of loan portfolio growth in the first quarter was below the average for the last four years (15.3%), it continued to rise, having gone from 12.8% in December 2013 to 13.6% in March 2014. Coupled with an interest rate spread that increased slightly,

Table 5
Real Annual GDP Growth, by Branches of Economic Activity

Branches of activity	2013				2013	2014	Contribution to annual growth (I Qtr. 2014)
	I Qtr..	II Qtr..	III Qtr..	IV Qtr..	Full Year	I Qtr..	
Agriculture, forestry, hunting and fishing	3.1	7.6	5.2	5.9	5.5	6.1	0.4
Mining and quarrying	1.0	4.3	6.8	7.8	4.9	5.6	0.4
Manufacturing industry	(4.8)	1.1	(0.2)	0.0	(1.0)	3.3	0.4
Electricity, gas and water	4.4	5.9	4.0	5.3	4.9	3.1	0.1
Construction	11.1	6.1	23.3	8.6	12.0	17.2	1.3
Buildings	11.1	11.9	29.9	(3.0)	11.4	7.9	0.3
Civil Works	11.3	1.9	18.8	20.6	12.7	24.8	1.1
Commerce, repairs, restaurants and hotels	2.9	4.3	4.6	5.5	4.3	5.6	0.7
Transport, storage and communication	2.1	3.2	3.5	3.5	3.1	4.5	0.3
Financial, real estate and company services	3.8	4.6	6.0	5.7	5.0	6.0	1.2
Social, community and personal services	5.0	5.1	5.0	6.2	5.3	6.3	1.0
Subtotal –aggregate value	2.7	4.3	5.6	5.2	4.5	6.3	5.7
Taxes minus subsidies	3.8	4.6	5.7	4.5	4.7	7.7	0.8
GDP	**2.9**	**4.6**	**5.8**	**5.3**	**4.7**	**6.4**	**6.4**

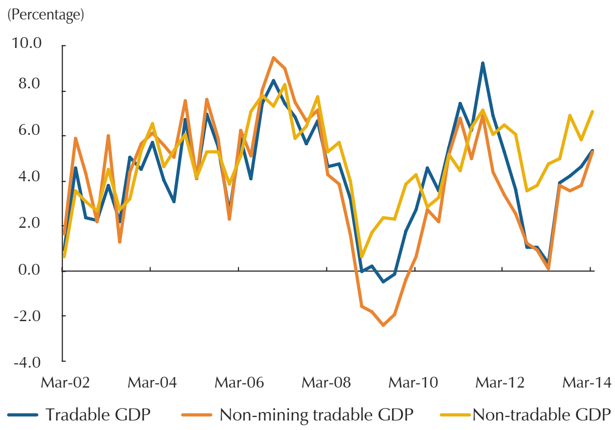
Source: DANE; Banco de la República calculations

this generated favorable performance in this sector GDP during the first three months of 2014 (6.0%), which was above the average of the past six years (4.7%). This item is still one of the major contributors to the economy, given its high share of GDP (18.7%).

One of the best performing sectors was social, community and personal services. It maintained its momentum and grew 6.3%. This was due largely to a sustained increase in the item related to public administration and defense (8.3%), partly because of wage hikes in the judicial branch.

In industry, a considerable build-up was observed during the first three months of the year (3.3% annually), following no growth in the fourth quarter of 2013. The sub-branches reporting the most expansion were those dedicated to coffee threshing, sugar, apparel and thread, as well as the group that includes oils, fats and other food products. However, industrial performance was influenced by the increase in working days this year, since Easter was during the second quarter. If this effect is discounted, industry would have grown 1.0%. Moreover, the temporary closure of Reficar affected production in the refined petroleum group (-5.5%). This sub-branch accounts for 12.5% of the total for the manufacturing industry.

Graph 15
GDP for Tradables, Non-mining Tradables and Non-tradables
(Annual growth)



Source: DANE; Banco de la República calculations

As has been the case for more than two years, Colombia's economic growth in the first quarter was led, once again, by the non-tradable sectors, although accelerations were observed both in this case and for tradables. For the first group of sectors, the annual increase was 7.1%, compared to 5.8 % in the previous period. GDP in the tradable sectors rose 5.4% as opposed to 4.6% in the fourth quarter of 2013 (Figure 15).

B. SHORT-TERM FORECASTS FOR GDP

The available figures on economic performance suggest GDP would have expanded at higher rates during the second quarter compared to those on record for the first three months of the year. Supply shocks that occurred during this period, particularly those related to oil infrastructure, would have exacerbated the statistical effect of fewer working days (which was incorporated already into the forecasts in previous editions of this report). However, domestic demand would have continued to grow at a good pace, with aggregate consumption increasing at rates slightly below those observed during the first quarter and with the momentum in investment having returned to normal.

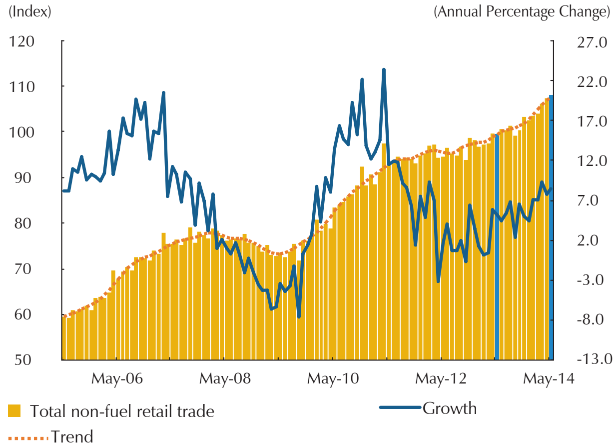
Growth in consumption during the second quarter would have been good, surpassing its historical average and coming close to the rate posted in the first quarter. This is according to the indicators of household spending, income and financing. Based on the latest information from the Monthly Retail Trade Survey (MRTS)[11] conducted by DANE in May, minor slowdowns in the growth of consumption of semi-durables and durables are expected, which probably were offset by good performance in non-durable goods and services.

Consumption would have increased at a good pace during the second quarter, above its historical average.

In this regard, the aggregate retail sales index was up 8.5% in May compared to the same month in 2013 (Graph 16). This placed the annual increase for April-May at 8.2%, which is similar to the first-quarter average (7.9%). The good performance in retail sales is confirmed when discounting sales of vehicles and motorcycles. The resulting aggregate grew at an annual rate of 8.7% during the same period (compared to 6.4% between January and March 2014).

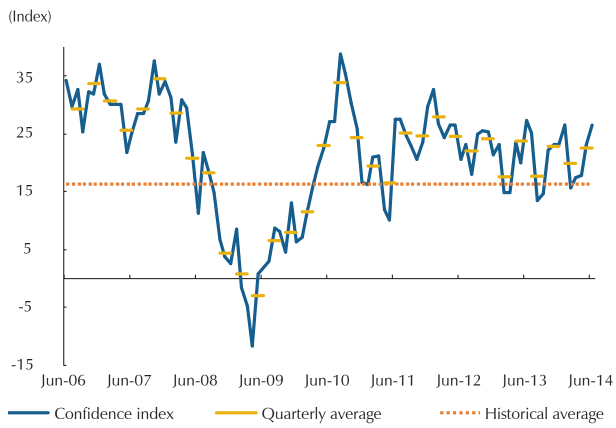
11 El DANE modificó recientemente la base y aumentó la cobertura de la antigua *Muestra mensual de comercio al por menor* (MMCM), la cual pasó a conocerse ahora como la EMCM.

Graph 16
Monthly Retail Trade Sample
(Total non-fuel retail trade, seasonally adjusted)



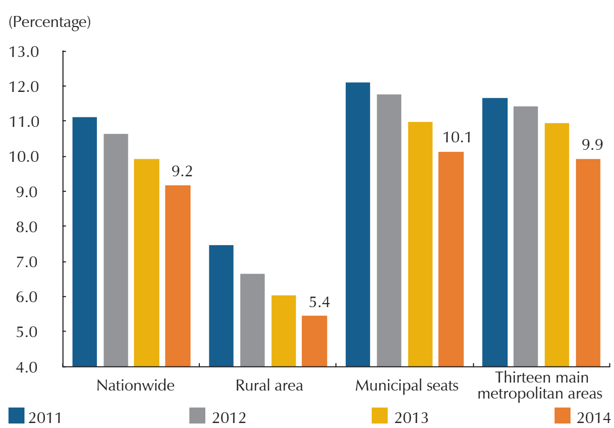
Source: DANE; Banco de la República calculations

Graph 17
Consumer Confidence Index and Quarterly Average



Source: Fedesarrollo

Graph 18
Unemployment Rate
(March-April-May Moving Quarter)



Source: DANE (GEIH); Banco de la República calculations

As for consumer durables, sales of automotive vehicles and motorcycles rose 5.4% during April-May, according to DANE. This figure is significantly less than the one on record for the first quarter (15.5%). Moreover, the retail sales figures released by ANDI-Fenalco-Econometrics show less momentum in this item during the second quarter, when the annual increase was just 1.4% as opposed to 11.1% during the first quarter. This suggests that household spending on goods of this type has not grown as fast as it did during the first three months of the year.

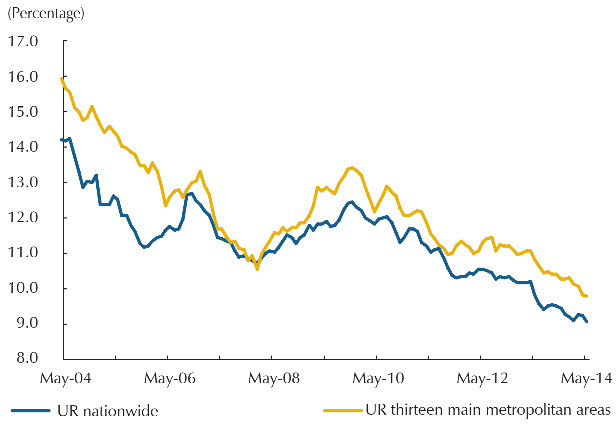
The behavior of other indicators shows that momentum in private spending during the second quarter would have been akin to what is suggested by the MRTS conducted by DANE. The Fedesarrollo consumer confidence index showed recovery in the margin, but the average for the April-June quarter is not far from the figure reported at the end of last year and the average for all of 2013 (Graph 17).

The recent results for the job market confirm the economy's good performance and help to explain the favorable behavior of household spending. With data up to the moving quarter ended in May, the unemployment rate continued to exhibit important annual reductions in all the geographic domains (Graph 18). After seasonally adjusting the national and the thirteen main metropolitan areas unemployment rate, the downward trend in both series since mid-2012 becomes evident (Graph 19).

The steady drop in unemployment was due to an increase in the employed population, which rose 2.0% and 2.8% annually during the moving quarter ended in May for the nationwide total and for the thirteen main metropolitan areas, respectively (Graph 20).

The number of employed population in the thirteen main metropolitan areas continued to rise in the salaried segment, which is associated with better

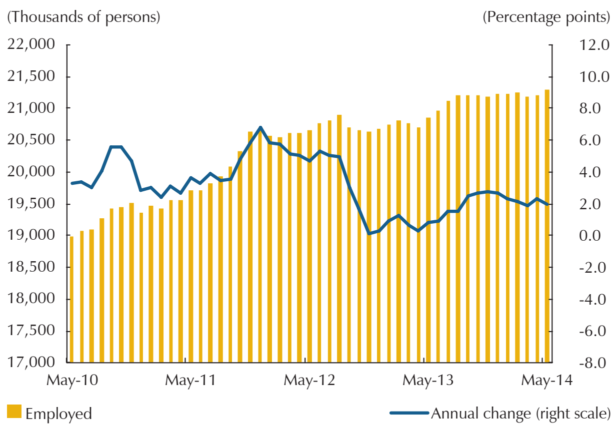
Graph 19
Unemployment Rate (UR)
(Seasonally adjusted moving quarter)



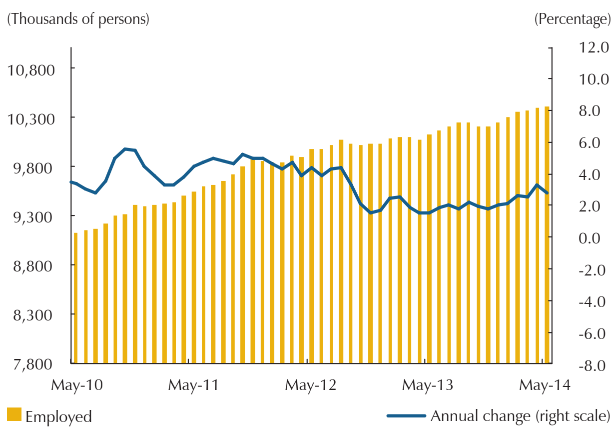
Source: DANE (GEIH); Banco de la República calculations

Graph 20
Number of Employed and Annual Change

A. Nationwide total



B. Thirteen main metropolitan areas



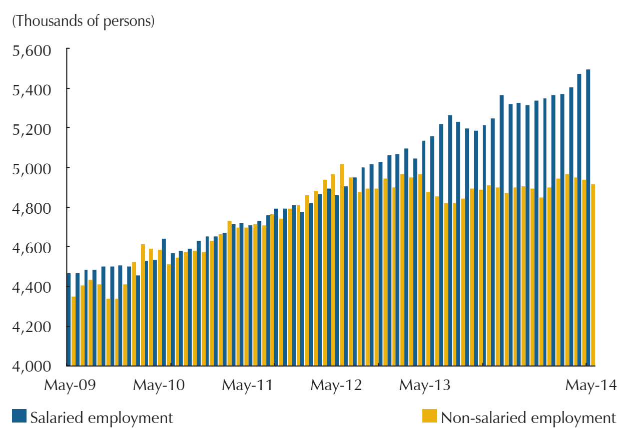
Source: DANE (GEIH); Banco de la República calculations

working conditions and higher earned income. This type of employment during the March-May quarter grew at an annual rate of 5.3%, while non-salaried employment was up by only 0.2% (Graph 21).

The momentum in consumer loans continued to favor household consumption. The slowdown in this portfolio came to a halt during the second quarter of 2014, thanks to an increase of 11.7% in consumer loans during the April-May quarter compared to the same period last year. They expanded at a similar pace during the first quarter of the year as well. Borrowing conditions for households remained ample as real interest rates on consumer loans stayed below their average since 1998, while credit card and usury rates showed a downward trend that continued up to the end of the second quarter (Graph 22).

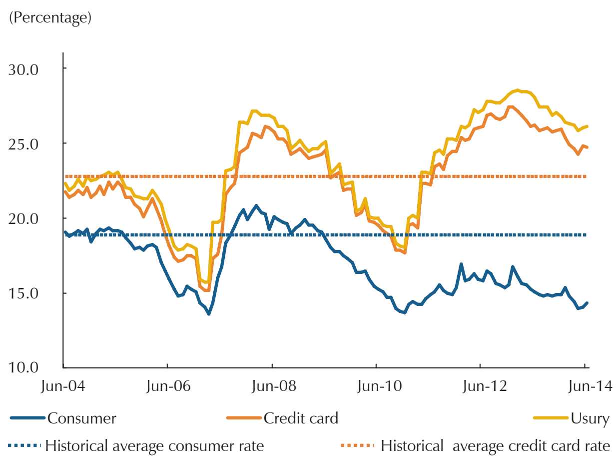
Gross fixed capital formation (GFCF) is estimated to have increased significantly during the second quarter, although less than the rates observed in the early months of 2014. The slowdown would have been due, in part, to normalization of the rate of expansion in investment in civil works, which would have experienced more momentum than the rest of the economy, but less than in recent quarters. If spending on building construction and civil works is discounted, the other items

Graph 21
Employment, by Type of Occupation
(Thirteen main metropolitan areas, seasonally adjusted moving quarter)



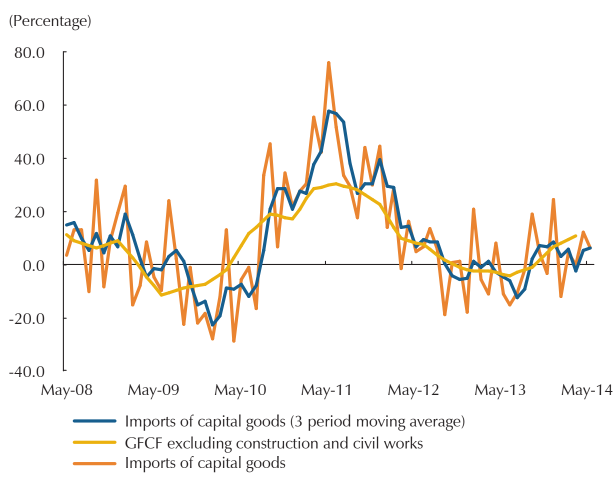
Source: DANE (GEIH); Banco de la República calculations

Graph 22
Real Interest Rates on Household Loans
(Non-food CPI deflated)



Source: Financial Superintendence of Colombia; Banco de la República calculations

Graph 23
Imports of Capital Goods (Real) and GFCF Excluding Building Construction and Civil Works
(Annual change)



Source: DANE, Banco de la República calculations

would have performed much as they did in the first quarter.

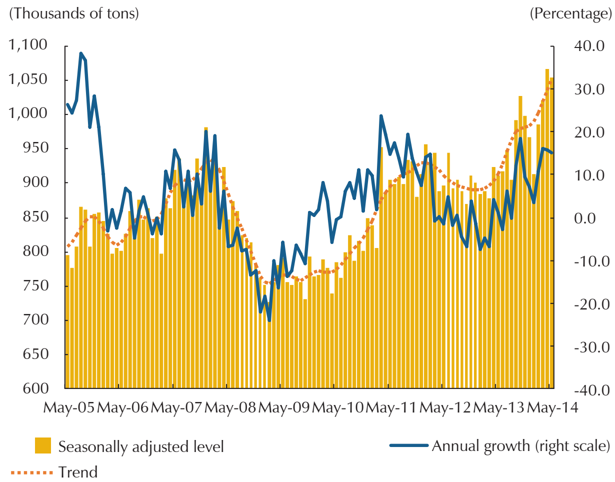
This forecast is based on information at May from Banco de la República's Monthly Survey of Economic Expectations (MSEE) and on the momentum in the figures for real imports of capital goods (Graph 23).

Finally, the second quarter would have seen slowdowns in foreign trade items, as indicated by the export and import figures published by DANE with information up to May. In the first case, the reduction in growth would have been influenced by the statistical effect of a high base of comparison in the same period of 2013. Moreover, traditional exports would have been affected by the various supply shocks that occurred primarily in the petroleum sector. On the other hand, import growth slowed following the high rates observed during the first quarter.

On the supply side, the balance of the various indicators at hand is mixed and supports the forecast for less growth in the second quarter compared to the first three months of 2014. Specifically, there is good news in sectors such as commerce, construction and coal production. However, slowdowns have been observed in other activities, such as coffee production and, to a lesser extent, the demand for energy. Oil production and the slaughter of livestock went down as well.

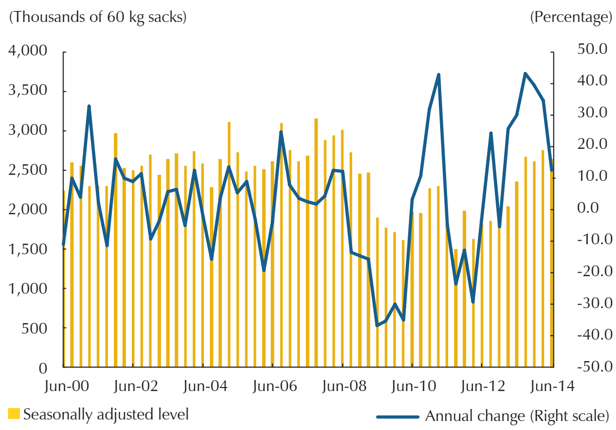
Construction continued to play an important role in the growth of the Colombian economy during the second quarter of the year. Building construction is expected to expand much as it did during the early months of the year. With the figures at May, cement production and shipment were up by 15.3% and 14.7%, respectively (Graph 24). Building permits performed well during April-May, with an average annual increase of 11.1% and 7.1% accumulated growth for the 12 months ended in May. As indicated, the sector is expected to post important figures, thanks to the government's stimulus measures (i.e. continuation of the social housing program and subsidized interest rates on home mortgages) and the positive trend in building permits. According to the above, civil works on the supply side are expected to perform well, but much less so than during the previous quarter (24.8%).

Graph 24
Cement Production
(Seasonally adjusted series, trend component and annual growth)



Source: DANE; Banco de la República calculations

Graph 25
Coffee Production
(Quarterly and Annual Growth)



Source: National Federation of Colombian Coffee Growers; Banco de la República calculations

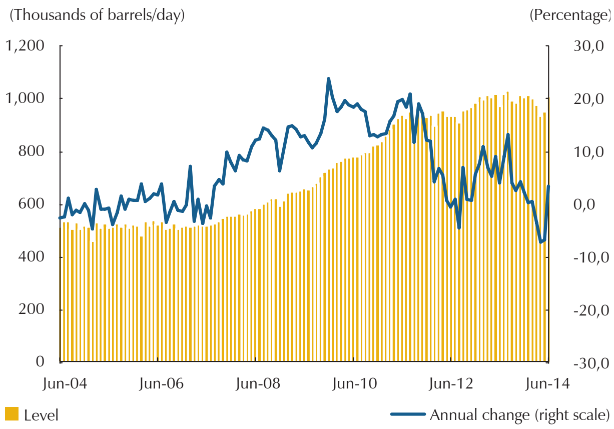
With respect to commerce, the positive perfor mance in retail sales, as mentioned earlier, suggests they will continue to grow at a good pace. The 2.4% annual increase in employment generated by this sector at May 2014 is consistent with this forecast and is explained by a rise in the hiring of permanent staff (3.9%) compared to a slowdown in the hiring of temporary personnel through employment agencies (-2.4%).

Less growth is expected for the agricultural sector compared to the first three months, given the sharp slowdown in coffee production and the reduction in the amount of livestock slaughtered. In the first case, seasonally adjusted figures published by the National Federation of Colombian Coffee Growers show the increase in production went from 34.9% in the first quarter to 12.4% in the second (Graph 25). Something similar occurred with the export figures at May reported by DANE. Meanwhile, the amount of cattle slaughtered was down 8.9% in April-May, having increased by 1.0% during the first quarter. This was due to the livestock retention phase that would have started a few months earlier.

The situation in mining is mixed. While oil production declined sharply, there appears to have been quite an improvement in the output of coal. Even though oil production surpassed one million barrels per day (1,008 thousand barrels per day [tbd]) in June, it averaged around 946 tbd during the second quarter. This implies an annual decline of 3.5% for that period, which is less than expected by those in the oil business and falls short of the target proposed by the country's economic authorities (Graph 26). The security problems that affected oil infrastructure during April 2014 are responsible for this performance. As for coal, the figures on export volume published by DANE indicate an increase in activity from 17.7% in the first quarter to 27% in April-May.

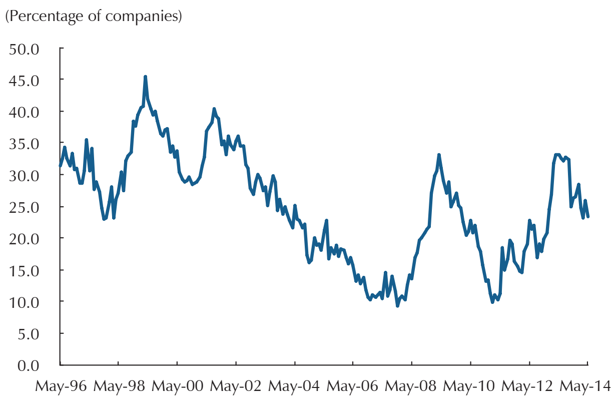
According to the figures from the Monthly Manufacturing Sample (MMS), the DANE industrial production index, without coffee threshing, accumulated an annual increase of 2.0% by May 2014. However the growth accumulated in April-May was close to zero (-0.2%). .

Graph 26
Oil Production
(Level and Annual Growth)



Source: National Hydrocarbon Agency (NHA); Banco de la República calculations

Graph 27
Evolution in Demand as a Problem for Industry



Source: Survey by the National Association of Colombian Businessmen

This is explained by the effect of fewer working days. When the industrial production index is seasonally adjusted to account for the calendar effects, the estimates suggest growth during the two-month period would have been 3.0%[12].The results within this branch continue to be mixed. Subsectors such as sugar mills (59.8%), chemicals (11.0%), beverages (7.5%), other food products (10.6%) and non-metallic minerals (5.3%) recorded positive growth, while others such as oil refining (-26.1%), precious and nonferrous metals (-21.1%) and manufactured metal products (-8.7%) reported significant declines. Coupled with the calendar effects (Easter and bank holidays), this makes it difficult to diagnose the sector's aggregate performance.

According to the National Association of Colombian Industrialists (ANDI), the data at May show employers have seen an increase in competition throughout the year from imports into the domestic market, but with improvements in the demand for their products (Graph 27). Also, the information at June from the Fedesarrollo business opinion survey shows industrial orders and inventory remained at relatively favorable levels. This was also the case with expectations for three months thereafter. The trend components suggest industry would continue to recover, although slowly.

All this appears to indicate GDP growth in Colombia during the second quarter of 2014 would be between 3.6% and 5.0%, with the most probable scenario being in the middle of that range.

As for the different branches of economic activity, the most dynamic would continue to be construction, social, community and personal services, and financial services. Industrial activity is expected to slow and exhibit almost no growth, but this would be a temporary phenomenon attributed to the number of working days. Industry is expected to resume a gradual path to recovery during the second quarter. The forecast range contemplates a

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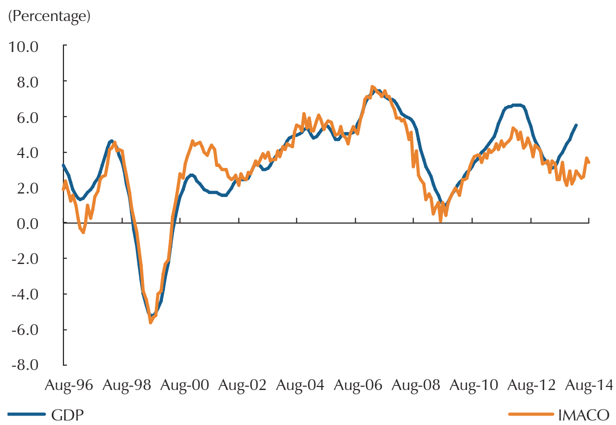
12 For a description of the method used to arrive at this estimate, see *Borradores de Economía*, no. 820. "Efectos calendario sobre la producción industrial en Colombia" by L. F. Melo and D. Parra (2014).

Graph 28
Imaco Leading Indicator for 5 Months of GDP[a/]



a/ 12-month accumulated annual growth
Source: Banco de la República calculations

considerable degree of uncertainty about the ultimate performance of investment in civil works and the behavior of government consumption.

The Imaco leading indicator (Graph 28), calculated using several sector variables with information at May, shows twelve-month accumulated growth below the central forecast. This situation was taken into account when preparing the fan chart of GDP forecasts shown in Chapter IV of this report. It is important to bear in mind that the Imaco methodology does not contain indicators for sectors such as construction, which are contributing significantly to growth; however, they are considered in the central forecast shown in the fan charts. So, that indicator might be underestimating GDP growth in Colombia.

III. Recent developments in inflation

Annual consumer inflation rose during the second quarter, approaching the midpoint of the target range somewhat faster than was anticipated in previous reports.

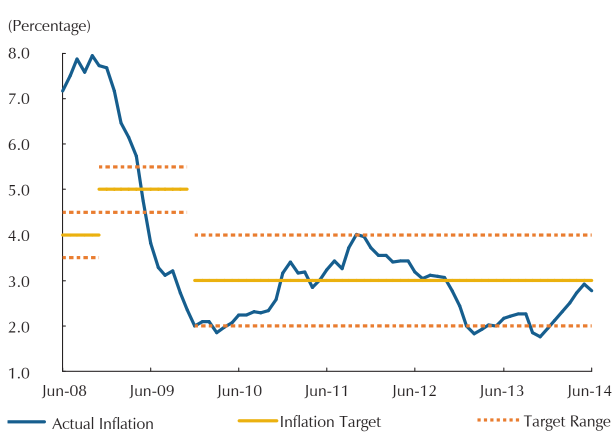
Core inflation also increased during the last three months and was 2.8% in June, according to the average of the indicators used by Banco de la República.

The second quarter continued to witness upward pressure on the prices of the tradable component of the CPI, even though the peso appreciated.

Much of the increase in inflation in recent months was still due to increases in food prices, which had reached very low levels last year.

Annual consumer inflation trended upward during the first five months of the year, falling only slightly in June, when it reached 2.79%. The level that month was higher than in March (2.51%) and December of last year (1.94%) (Graph 29 and Table 6). Annual inflation at June was above what the market expected and more than Banco de la República's technical staff had anticipated in previous edition of the Inflation Report. However, it did remain within the target range established by the Board of Directors of Banco de la República (between 2.0% and 4.0%).

Graph 29
Total Consumer Inflation



Sources: DANE and Banco de la República.

Various events contributed to the increase in inflation during the first half of the year. Some were concentrated largely in the first quarter and others, in the second. An important event in the first quarter was the disappearance of the downward effect on annual inflation originating with the reduction in certain indirect taxes on fuel, raw

Table 6
Consumer Inflation Indicators
(At June 2014)

Descriptión	Dec-12	Mar-13	Jun-13	Sept-13	Dec-13	Mar-14	Apr-14	May-14	Jun-14
Total	**2.44**	**1.91**	**2.16**	**2.27**	**1.94**	**2.51**	**2.72**	**2.93**	**2.79**
Excluding food	**2.40**	**2.11**	**2.48**	**2.36**	**2.36**	**2.62**	**2.85**	**2.76**	**2.66**
Tradables	0.77	1.13	1.10	1.34	1.40	1.65	1.83	1.95	1.94
Non-tradables	3.92	3.85	3.78	3.70	3.76	3.55	3.51	3.68	3.45
Regulated items	1.91	0.20	1.98	1.24	1.05	2.21	3.05	2.14	2.14
Food	**2.52**	**1.41**	**1.34**	**2.05**	**0.86**	**2.23**	**2.39**	**3.35**	**3.11**
Perishable	-3.90	-1.86	2.44	5.94	-0.16	3.17	6.89	10.97	8.92
Processed	2.83	1.25	-0.11	0.18	-0.24	0.92	0.51	1.23	1.44
Eating out	4.90	3.22	3.51	3.74	3.26	4.13	3.73	3.75	3.52
Core inflation indicators									
Excluding food	2.40	2.11	2.48	2.36	2.36	2.62	2.85	2.76	2.66
Core 20	3.23	2.78	2.83	2.79	2.72	2.86	2.80	3.14	3.04
CPI excluding perishable foods, fuel and public utilities	3.02	2.51	2.14	2.19	2.19	2.53	2.54	2.63	2.53
Inflation excluding food and regulated items	2.55	2.67	2.63	2.69	2.74	2.74	2.80	2.95	2.81
Average of all the indicators	**2.80**	**2.52**	**2.52**	**2.51**	**2.51**	**2.69**	**2.75**	**2.87**	**2.76**

Source: DANE; Banco de la República calculations

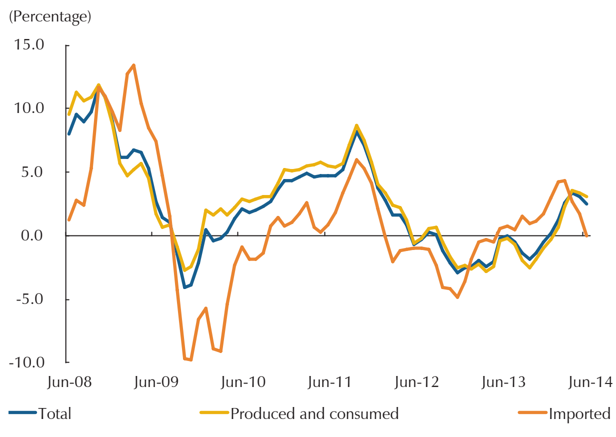
materials, vehicles and some foods at the start of last year. Another was the freeze or reduction in rates on different regulated services throughout 2013, particularly transportation and garbage collection. In both cases, the reductions were temporary and were not repeated in 2014. This generated a low base of comparison for calculating annual inflation.

Similar effects were also generated by an abundant agricultural supply the year before, due to highly favorable weather conditions. Prices fell below normal levels as a result. These conditions disappeared during the first half of 2014, and relative food prices trended upward during the first two quarters of 2014.

Annual inflation in June was more than anticipated by the market and by Banco de la República's technical staff.

During the second quarter, consumer prices also were affected by moderate upward pressures, the main one being accumulated depreciation of the peso against the dollar between the end of last year and March 2014. This was reflected in price increases for a wide range of tradable goods that began in the first quarter of this year and continued during the second, with slightly more intensity than expected. Although depreciation of the peso reversed in the last three months, the pass through of this movement to consumer prices is not clearly evident as yet.

Graph 30
PPI by Origin
(Annual change)

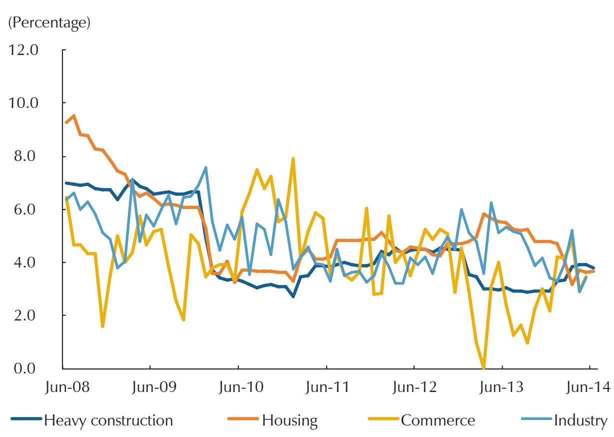


Source: DANE

Peso depreciation in the early months of the year also brought inflationary pressures to bear on non-labor costs; these eventually would have passed through to consumer prices, to some extent. The annual change in the producer price index (PPI), an indicator that is an approximation to those costs, increased between December of last year (-0.5%) and April (3.4%). However, in May and June, the appreciation observed since April would have reversed this trend, in part, since the PPI fell to 2.5% last month (Graph 30). The pass through of exchange-rate movement to producer prices is faster and occurred mainly through prices on imported goods, as suggested by the behavior of the imported PPI.

On the other hand, wage-cost inflationary pressures remained under control, favored by the reduction in payroll costs. As of January 2014, employers are no longer required to contribute to health care, which amounted to 8.0% of the employee's salary. Moreover, wage costs in industry, commerce, housing and services posted hikes between 3.0% and 4.0%, consistent with the inflation target for this year (Graph 31). In the case of the manufacturing industry, these two events led to annual adjustments in remuneration (the sum of wages and employee benefits) that came to -0.2% in May.

Graph 31
Nominal Wages
(Annual percentage change)



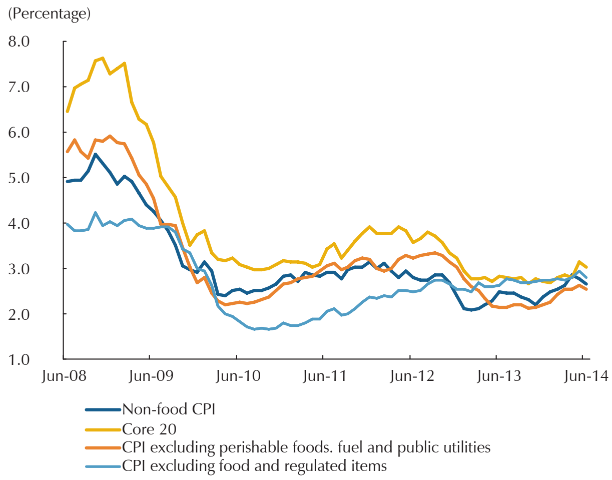
Source: DANE; Banco de la República calculations

Despite the good performance of economic activity and spending during the first half of the year, as suggested by the data at hand (see Chapter II), there still is no evidence of important demand-side inflationary pressures. This is judging by the relative stability in the growth of the consumer price index (CPI) for non-tradables in recent months. However, as noted in Chapter IV of this report, the output gap would already be in positive territory, so price pressure arising on this front cannot be ruled out for the remainder of the year and in 2015.

A. CORE INFLATION

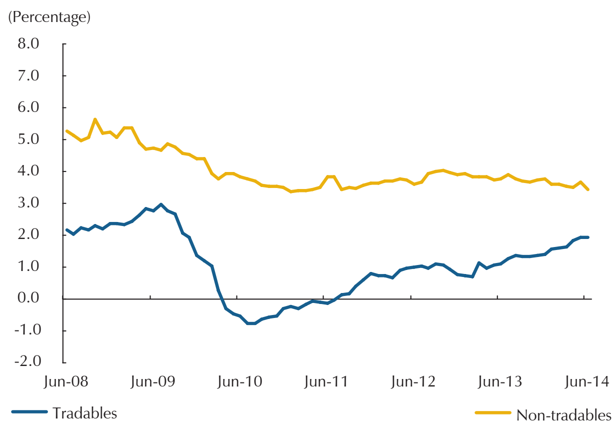
Core inflation, estimated as the average of the four indicators regularly monitored by Banco de la República, increased by 7 basis points (bp) between March and June, ending the first half of the year at 2.76%. Except for the Core 20 (3.0%), which was the highest, all the core inflation indica-

Graph 32
Core Inflation Indicators



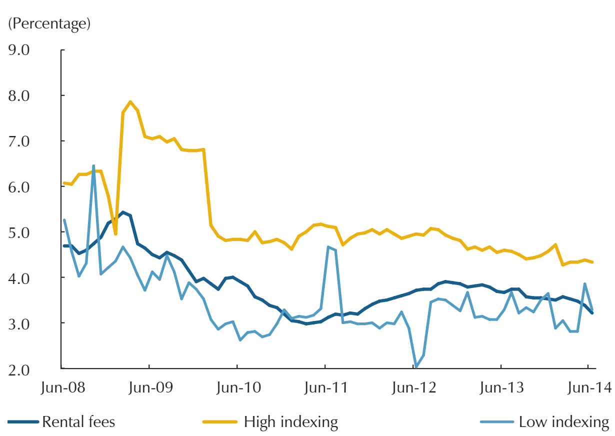
Source: DANE; Banco de la República calculations

Graph 33
Tradable and Non-tradable CPI Excluding Food and Regulated Items
(Annual change)



Source: DANE; Banco de la República calculations

Graph 34
Non-tradable CPI
(Annual change)



Source: DANE; Banco de la República calculations

tors were below the inflation target. The CPI excluding perishable foods, fuel and public utilities was the lowest (2.5%). The non-food CPI rose slightly between March (2.6%) and June (2.7%) (Graph 32, Table 6).

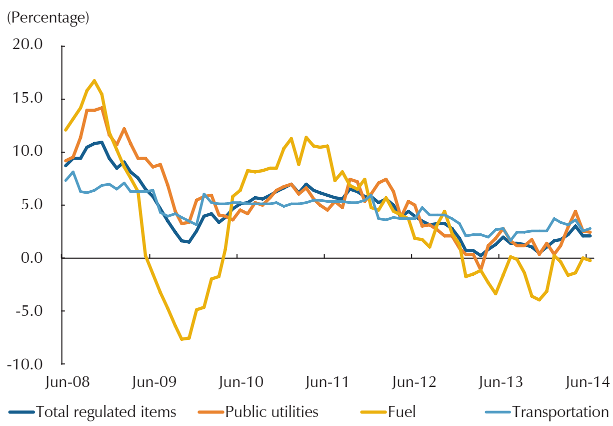
A look at the components of the non-food CPI shows the tradable sub-group (excluding food and regulated items) was the only one to generate upward inflationary pressures so far this year, particularly in the second quarter. The outcome in June (1.9%) was 54 bp, which is 29 bp more than was observed in December and March, respectively, and also slightly more than was forecast in previous editions of this report (Graph 33).

Prices for vehicles, air fares, certain electrical appliances and some non-durable consumer goods, among others, rose during these months, fueled in part by depreciation of the peso at the beginning of the year, although the momentum in consumption also could have contributed to these increases. It is important to note that pass-through of the movement in the exchange rate to consumer prices operates with a lag of three to four months in Colombia. So, even though the peso appreciated as of April, some upward pressure on the prices of these goods was still being felt in June.

Contrary to what happened with the tradable component, the annual change in the non-tradable CPI (excluding food and regulated items) and in the regulated CPI declined during the second quarter. In the first case, there was a reduction of 10 basis points compared to March, ending the first half of the year at 3.5%. The results for the non-tradable sub-basket were mixed: while items with high indexing remained stable at 4.3% during the second quarter, those with low indexing increased from 2.8% in March to 3.3% in June. Inflation in rental fees, the item with the most weight in the basket, declined from 3.6% in March to 3.5% in June (Chart 34). The annual variation in rental fees has declined gradually since late 2012. Recently, this has been the case particularly for middle and low-income families, possibly due to an increase in the supply of new housing for these population groups.

The downward trend in the non-tradable CPI (excluding food and regulated items) observed since the end of last year contrasts with the added momentum in economic activity and the widening in the output gap. It is possible that some production costs have experienced moderate adjustments so far this year and that inflation expectations anchored to the target might have offset the increased upward pressure from demand.

Graph 35
CPI for Regulated Items and its Components
(Annual change)



Source: DANE; Banco de la República calculations

With respect to the regulated CPI, the decline in its annual change to 2.1% during the second quarter comes on the heels of increases between late last year and March 2014 (Graph 35). The only upward pressure on regulated items originated with gasoline prices, which rose due to higher international prices and depreciation of the peso earlier this year. In this case, recent appreciation of the peso has yet to pass through to consumer prices. Furthermore, the nearly $200 peso decline in the price of gasoline last year, given the reduction in indirect taxes decreed in the latest tax reform bill, further increased in the annual change in the CPI for this item during the first quarter, thanks to a low base of statistical comparison.

In contrast to the situation with gasoline, the annual change in the CPI for public services dropped by 46 percentage points during the second quarter, ending June at 2.5%. Energy has behaved erratically so far this year, with several significant adjustments. For example, the energy rate rose by nearly 2.7% in April, and the energy CPI has increased 5.4% during the course of the year to date. This upward trend is the product of speculation on the energy exchange, given the growing probability of *El Niño* weather and the increase in the production of thermal energy.

As for the rates for natural gas, a stronger peso since April, coupled with deregulation of the price of natural gas, allowed for a decline in rates during recent months. Accordingly, the annual change dropped to 7.7% in June, from 12.9% three months earlier. It is important to bear in mind that the price of gas from the Guajira region, prior to deregulation, was linked to changes in the international price of fuel oil.[13]

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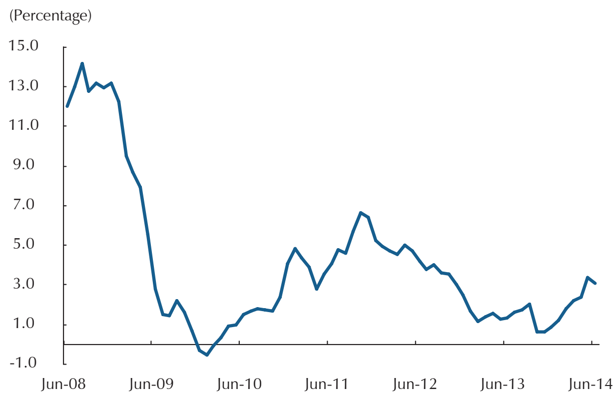
13 For more information on the new rules deregulating the price of gas in Colombia , see Resolution 088/2013 and Resolution 137/2013 issued by the Energy and Gas Regulation

Graph 36
Food CPI
(Annual change)



Source: DANE; Banco de la República calculations

B. THE FOOD CPI

Although the annual change in food prices slowed during June, the trend in the second quarter was upwards and exceeded the market's expectations, as well as those of Banco de la República. After posting its lowest level in November 2013 (0.6%), the annual change in food accelerated to 2.2% in March and 3.4% in May, before declining to 3.1% in June (Graph 36).

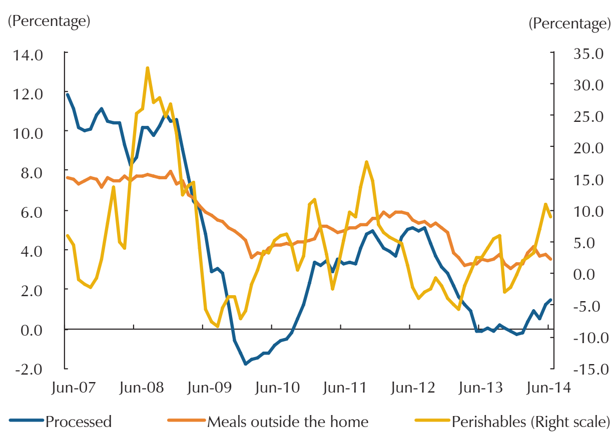
The added pace of the rise in food prices during much of the first half of the year was associated with the disappearance of several factors that favored low inflation in this group last year and the surge in upward pressure during the first half of 2014.

Ideal weather conditions throughout 2013 raised agricultural productivity, resulting in larger food supplies and falling prices. International food prices also trended downward or stayed at historically low levels. Moreover, the latest tax reform, which took effect in 2013, exerted downward pressure on the food group by reducing the value added tax (VAT) charged on some agricultural input, various foods, and meals outside the home, among other items. However, with the disappearance of these downward effects, other factors began to operate in early 2014 that have caused food prices to rise.

One of them is the depreciation in the exchange rate between the peso and the dollar during the first three months of the year; another is the increase in international food prices in the first four months of 2014, which helped to boost the processed food sub-basket from -0.2% in December to 0.9% in March and 1.4% in June (Graph 37). Added to this is the recent increase in the price of meat (4.4% to date this year), which could be explained by the onset of the cattle retention phase and the widespread drought in the Atlantic and Santander regions.

This latest weather disturbance, coupled with less planting due to the low prices witnessed last year and fears of *El Niño* weather in the coming months, would explain the reduction in the supply of perishable foods and the increase in their pri-

Graph 37
Food CPI, by Groups
(Annual change)



Source: DANE; Banco de la República calculations

Commission (CREG).

The added inflationary pressures during the second quarter came from food.

ces. In fact, prices for perishables went from an increase of 0.2% in December of last year to 3.2% in March and 8.9% in June, largely explaining the acceleration in annual inflation with respect to food and the total CPI.

The foregoing rising effects also are evident with respect to meals outside the home, which surged between December (3.3%) and March (4.1%), then declined to 3.5% in June. In this case, the price hikes are still low compared to those of last year, which might indicate that demand-side pressures up to June remained limited.

IV. Medium-term forecasts

The Colombian economy will continue to grow at a good pace throughout the rest of 2014, driven by domestic demand.

The amount of growth anticipated for the full year is around 5.0%, which is higher than was anticipated in the previous report.

Consumer inflation would be slightly over 3.0% at the end of this year and the beginning of 2015.

Some upside risks to inflation in the mid-term come from potential demand pressures, a tighter job market and possibly higher expectations, due to the food and energy supply shocks that could emerge in the event of *El Niño* weather.

A. ECONOMIC GROWTH

The forecasts for growth in 2014 as a whole were revised upward as a result of the good performance of consumption and investment in civil works during the first quarter.

The medium-term economic growth forecasts presented in the previous Inflation Report were revised upwards in this edition. The increase in GDP growth predicted for 2014 as a whole was influenced by the results of the first quarter, which were higher than the market anticipated and surpassed the expectations of Banco de la República's technical staff. The performance of consumption and civil works construction during that period prompted to an upward revision of the forecasts for these items during the remainder of 2014. Accordingly, the estimates on the momentum in the Colombian economy this year suggest GDP would increase at a slightly higher annual rate than was the case in 2013 (4.7%). Production is also expected to perform well in 2015, although less so than in 2014, but more in keeping with what is estimated as its long-term growth rate.

During the remainder of 2014 and in 2015, the external variables would continue to favor expansion of the Colombian economy, although with less momentum than in previous years.

The forecasts presented in this section are consistent with the international scenarios described in Chapter I. Accordingly, Colombia's major trading partners are expected to see somewhat less growth than in 2013. Furthermore, no major changes in international liquidity conditions are anticipated during the remainder of the year. Income through remittances from abroad would register positive growth rates, although below than what they were in 2013. FDI inflows during 2014 also would be lower than those reported for the past year, especially in the oil sector. Likewise, terms of trade are expected to be high, but slightly below the level in 2013. Therefore, the remainder of 2014 would continue to see external variables that favor expansion of the Colombian economy, although with less momentum than in previous years. As for 2015, external demand is expected to perform better, as a product of overcoming the various supply shocks in the United States economy and continued recovery of the European economy. Terms of trade are not expected to change significantly in 2015 compared to 2014.

On the domestic front, the forecasts in this report assume that investment in civil works and public consumption will continue to fuel growth in 2014, similar to what occurred during the first quarter of the year, although the momentum would ease at the onset of 2015. By the same token, prolongation of the national government's policies to stimulate a broader supply of housing would continue to bear fruit in terms of high growth rates for investment in building construction this year and the next. On the other hand, the changes in the stance of monetary policy implemented since April of this year are beginning to have somewhat of a moderating effect on productive activity within a horizon of four to six quarters, according to estimates by Banco de la República. Therefore, domestic liquidity in 2014 is expected to remain broad, and lending should grow at high rates compatible with further economic expansion. However, the pace of loan portfolio growth is expected to slow next year, once the hike in the benchmark rate is passed on to the productive sector through the various monetary policy transmission channels.

Prolongation of the national government's policies to stimulate a broader supply of housing would continue to bear fruit in terms of high growth rates for investment in building construction this year and the next.

Consequently, domestic demand during the remainder of this year would more than offset the lower momentum anticipated in the international context. This being the case, consumption and investment would be the spending components that contribute the most to GDP growth in 2014, at a slightly higher rate than in 2013. As for 2015, it is assumed that the contribution to GDP growth will occur in a more balanced way between external and domestic demand.

As for private consumption throughout 2014, the growth rate is expected to surpass its average since 2000 (4.0%) and be similar to what it was last year. This momentum is based on ample availability of loans at relatively low interest rates and high levels of consumer confidence. It should be

The anticipated expansion in investment in civil works and in public consumption ensures significant stimulus to private consumption via the spending multiplier effects.

noted that the expectation component of the confidence index has recovered in recent months, suggesting vigorous household intention to purchase during the rest of the year. On the other hand, the anticipated expansion in investment in civil works and in public consumption, as detailed below, ensures significant stimulus to private consumption via the spending multiplier effects. Equally favorable is the higher price forecast for certain commodities (such as coffee) on which the income of a large segment of Colombian households depends.

Final government consumption is expected to surpass the increase in 2013 and the average since 2001. As stated in the Medium-term Fiscal Framework published by the Ministry of Finance and Public Credit in June 2014,[14] national government spending associated with commitments, such as those acquired for the personal services of employees in the judicial branch, are expected to increase this year. In addition, better performance is anticipated for local and regional government spending, given the forecasts for a smaller fiscal surplus this year. On the other hand, the momentum in public consumption is expected to slow down in 2014, partly because of the high base of comparison that would be registered for 2014; hence, the forecast is for growth rates close to their average as of 2001.

As for gross capital formation, a build-up in the growth of this item of GDP with respect to 2013 is anticipated. In principle, the recovery forecast for industry and the anticipated momentum from chaining among sectors should favor investment spending on machinery and equipment. Additionally, the fleet renewal plans of several air carriers would allow investment in transportation equipment to expand at positive rates, after two consecutive years of declines. On the other hand, the likely start-up of a new livestock retention phase, along with the coffee plantation renewal process that is still ongoing, favor investment performance in the agricultural sector this year and the next.

During the remainder of 2014 and in 2015, investment in the construction of buildings and civil works would increase at significant rates, above those for the rest of the economy.

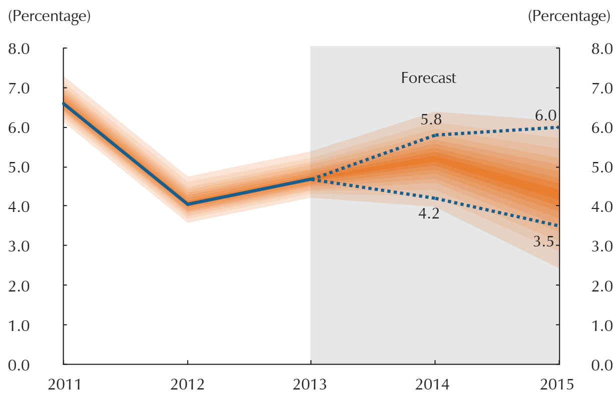
Investment in construction of buildings and civil works would increase at significant rates, above those for the rest of the economy. The low-income housing programs being implemented by the national government are expected to continue to provide a major boost to the sector during the remainder of 2014 and in 2015, as will the continuation of subsidized interest rates for the purchase of low- income housing (LIH) and housing of "priority interest" (HPI). With respect to civil works, the continuation of major road construction and repair projects and the resources earmarked for modernization and intervention in the airports of several cities throughout the

14 Ministry of Finance and Public Credit (Macroeconomic Policy Department), Marco Fiscal de Mediano Plazo, June 2014.

country suggest this item will see double-digit growth rates. Furthermore, added budget execution by local and regional governments using the resources from royalties indicates construction of other civil infrastructure will continue to be dynamic in 2014.

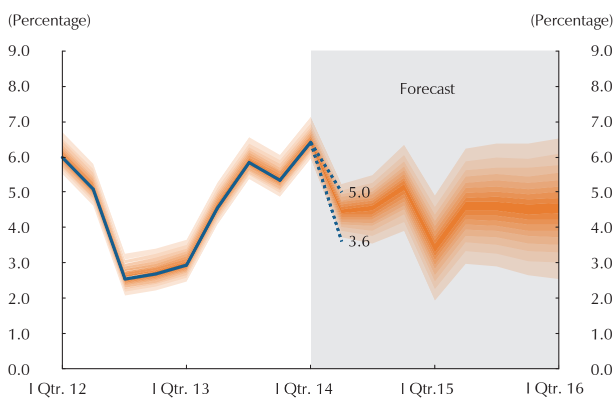
It should be noted that the resources earmarked for the country's fourth-generation (4G) infrastructure projects would begin to be spent in the coming years; consequently, they will have no visible impact on the Colombian economy this year. The forecasts in this report assume the effect of these projects will begin to be felt largely towards 2016. However, as the fan chart of GDP growth illustrates, there is uncertainty about more of these resources being spent throughout the coming year (Graphs 38 and 39).

Graph 38
Annual GDP Growth Fan Chart



Source: DANE; Banco de la República calculations.

Graph 39
Quarterly GDP Annual Growth Fan Chart



Source: DANE; Banco de la República calculations

On the supply side, the most dynamic sectors in 2014 should be construction (for the reasons mentioned earlier), social, personal and community services, and financial services. Mining would expand less than in 2013. Finally, after two years of contraction, a positive growth rate is forecast for industry, although less than the rate for the economy as a whole.

Construction in 2015 would continue to make an important contribution, as noted earlier. The forecast for mining and industry during that same year points to higher growth rates than in the last two years, given the added strength in their recovery processes. The momentum anticipated for the other sectors suggests growth would be near their potential.

As for the mining sector, this report assumes coal production will continue to recover during the remainder of 2014, following the problems with law and order and transport that complicated its production chain in 2013. The new forecasts indicate that production in this sub-branch would expand by more than 10% in 2014 as a whole (compared to the single-digit forecast in the previous report). The forecast was revised upward in light of the considerable momentum observed during the early months of the year, when production rose 33.3% despite a degree of paralysis in production and export activities by one of the most important mining companies in Colombia. In contrast, the forecast for average oil production during the year was reduced in this report, given the low

The forecast for average oil production in 2014 was lowered in this report.

outcome observed during the first half of the year. At present, average production is not expected to exceed one million barrels per day in 2014. Considering the foregoing, it is estimated that mining would grow at a rate lower than the economy as a whole, and lower to the one observed for 2013 (4.9%). For 2015, both coal and oil productions are expected to resume the significant growth witnessed in past years, partly because the supply shocks that occurred last year are temporary. Moreover, the investments made in infrastructure to transport these products should contribute to increase growth rates for the sector.

The GDP forecast for 2014 assumes that industry would recover somewhat, given the investment efforts made in past years, and the diversification of export products and markets. However, according to perception reported by businessmen in the ANDI surveys, some branches would continue to face strong competition from imports. In other cases, such as publishing, printing and related activities, the possibly of a slowdown will continue, given the profound structural changes affecting this sector worldwide.

Additionally, closure of the Cartagena refinery (Reficar) throughout 2014 would result in an annual reduction in oil refining. The fact that this subsector accounts for approximately 12.5% of industry, significantly limits the capacity for growth of the industrial sector as a whole. However, a considerable increase in refined products is anticipated as of 2015, which should have a favorable impact on industrial performance.

Finally, with respect to social, personal and community services, the momentum in government expenditure is expected to continue to play an important role as a source of growth in 2014, especially in the areas associated with public administration, social assistance and health care. Financial services would still contribute actively to the growth of the Colombian economy, not only because they account for a considerable share of the sector (19.6%), but also due to the persistent momentum that is expected to come from financial system investments and loan portfolio growth. With the figures at May 2014, these two aggregates reported 4.25% and 11.43% real annual growth, respectively.[15] In 2015 they also would help the economy to perform near its long-term levels.

It is important to consider that closure of the Cartagena refinery (Reficar) throughout 2014 would result in an annual reduction in oil refining.

Based on the above, the forecast for output growth in the most probable scenario is around 5.0% for 2014, within a forecast range of 4.2% to 5.8%. The span of this range remains broad, since there is a great deal of external and domestic uncertainty. The floor and ceiling of the forecast range are

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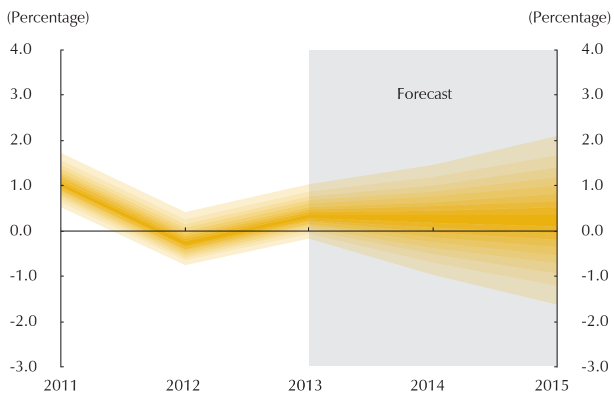
15 Report by the Financial Superintendence of Colombia, “Actualidad del sistema financiero colombiano,” May 2014.

related to the low and high scenarios in the international context, as outlined in Chapter I. With respect to 2015, the forecast suggests GDP growth will be good, although less than what it would be in 2014. A slowdown in growth rates for public consumption and investment is expected for next year, as summarized earlier.

The risk balance is shown in the growth fan charts (Graphs 39 and 40). The main downside risks are associated with less growth for Colombia's trading partners and faster-than-expected normalization of the monetary policy stance in the United States, which could increase the cost of financing in 2015. The main upside risk to GDP comes from more dynamic investment than what is contemplated in the central forecast, due to the fourth-generation highway construction projects that have been announced.

The latest output gap estimates for the central forecast suggest this variable would have remained near zero, on average, during 2013 and would be slightly above that level in 2014. For this last year, the models show a larger gap than the one obtained in the September report, which is consistent with the growth forecast for 2014.

Graph 40
Output Gap Fan Chart



Source: DANE; Banco de la República calculations

As always, the uncertainty associated with these estimates is important. According to the risk balance shown in Graph 40, the gap in 2013 would have been between 0.2% and 1.0%, with high probability. This balance has less of a downward bias than the one presented last quarter. As for 2014, the models indicate uncertainty remains high and the forecast range is still broad, with an upward bias (between 0.9% and 1.5%). The uncertainty is even greater in 2015, with the range at -1.6% to 2.1%.

The models by Banco de la República suggest that the unemployment rate in 2013 was very close to the non-accelerating inflation rate of unemployment (NAIRU). The labor market gap would continue to close in 2014, which suggests inflationary pressures originating from that market will remain low.

B. INFLATION

1. Forecast

The central models estimated for this report (MMT and Patacon) continue to show annual growth in consumer inflation for the rest of the year at le-

The central forecast for inflation was increased slightly in this report compared to the one last quarter.

vels above the mid-point of the target range. Inflation would stabilize at around this level towards 2015. The central forecasts in both models rose slightly for December of this year and for early 2015, given the results outlined in the March edition of this report.

As with the exercise three months ago, the upward revision of the central forecast on this occasion is attributed, once again, to supply factors that mainly affect the behavior of food prices. The rise in these prices in recent months, especially for perishable foods, was sharper than expected and raised the forecasts for annual inflation in the food CPI three quarters ahead.

Previous reports noted the annual change in food and total inflation should increase in 2014 as a result of prices returning to normal after the extremely low levels observed in 2013, given the temporary events explained earlier. In recent months, this trend accelerated due to factors such as limited rainfall in several parts of the country and the onset of the livestock retention phase, which would continue to have an impact on prices in the coming quarters.

Generally speaking, the projected increase in the annual change in food inflation during the remainder of the year and in early 2015 would originate with domestic rather than external factors, because the models do not contemplate important international price hikes for products of agricultural origin imported by the country. Moreover, in the coming months and in the medium term, appreciation of the peso since April will tend to pass through, to some extent, to prices for foods with a high imported content, at an exchange rate that should not generate a significant amount of pressure.

The food price hikes between now and the first half of next year will have a temporary component that obeys to the usual cycle in this variable. Accordingly, the annual change in the food CPI, which would be above 3% for several months, would drop by mid-2015 to fluctuate around that figure. Importantly, the central inflation forecast in this report does not imply the presence of *El Niño* weather during the coming quarters. If it does occur, there would be more of an upward trend in food prices than is contemplated in the central forecast.

The added momentum in domestic demand anticipated in this report brought upward pressure to bear on the forecast for inflation. .

A second factor that raised the central forecast for inflation is the anticipation of added momentum in economic activity compared to the forecast presented in the previous edition of this report, particularly with respect to domestic demand. For that reason, the output gap is expected to be in positive terrain for 2014 and 2015, contrary to the prediction in the previous report. Accordingly, the demand side pressures on inflation in the medium and long term are expected to be somewhat higher than was forecast in March.

The largest gap in the forecasts is reflected, above all, in an increase in the annual change in the non-tradable CPI excluding food and regulated items towards next year, since it takes three to six quarters for prices react to a change in demand. Prices for food and tradables excluding food and regulated items would be affected as well; however, in these cases, supply factors play an important role in determining how prices evolve, as do foreign prices and the exchange rate.

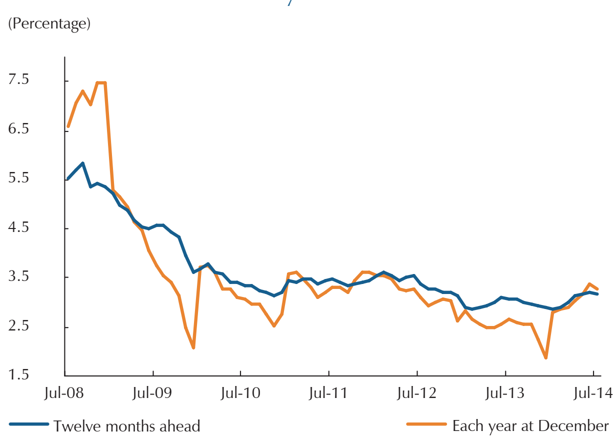
Regulated prices also exerted upward pressure on the inflation forecast presented in this report. The annual change anticipated for the regulated CPI was raised for the next four quarters, owing to energy rate hikes, which were more than expected, and the increase in international oil prices projected for the baseline scenario. In the case of energy, prices on the commodity exchange market rose considerably in the last four months and, although these increases were reversed at the beginning of July, some of them likely passed through to consumer prices, due to the way distributors and marketing companies set up their contracts to supply the generating companies.

As in the previous quarterly report, the expectations for inflation presented in this edition again exert upward pressure on the central forecast, although slight. According to Banco de la República's monthly survey of financial market analysts, conducted in early July, inflation is expected to be 3.3% by December of this year and 3.2% at 12 months. In both cases, the forecast is slightly higher than the one obtained three months ago (3.0% and 3.1%, respectively) (Graph 41).

The quarterly survey of entrepreneurs showed similar results. On this occasion, they forecast 3.0% inflation by December of this year and 2.9% at twelve months. In both instances, these expectations are higher compared to the April survey, but are more aligned with the target than the monthly survey (Graph 42). Expectations at two, three and five years derived from the TES yield curve were above 3.0% in July, having been below that rate in April. The forecasts at two years were the highest (3.3%) (Graph 43).

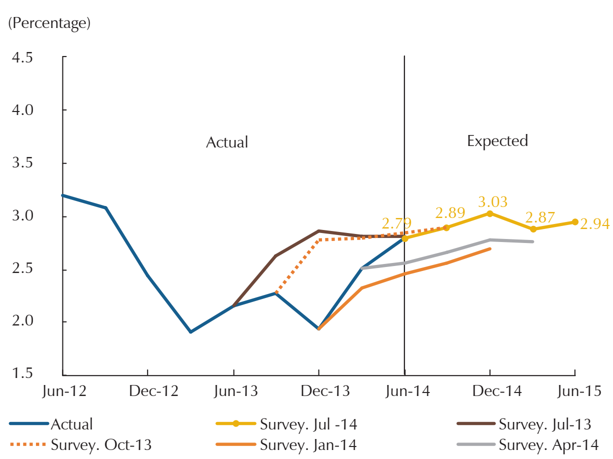
The increase in the central forecast due to the aforementioned factors was mitigated by less

Graph 41
Annual Inflation Forecasts by Banks and Stock Brokers



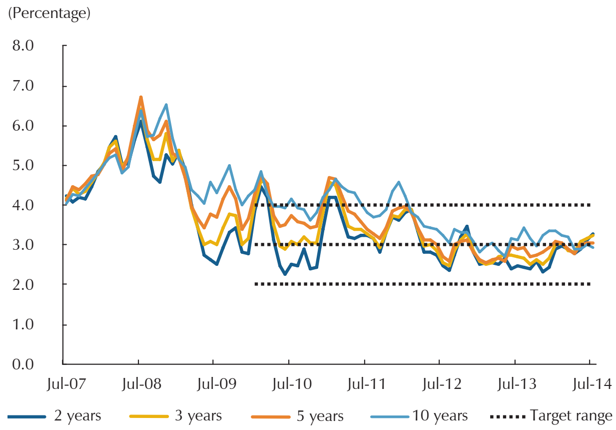
Source: Banco de la República.

Graph 42
Actual Inflation and Inflation Expectations
(At three, six, nine and twelve months)
(Annual inflation)



Sources: DANE and Banco de la República.

Graph 43
Inflation Expectations Derived from TES
(At two, three, five and ten years)
(Monthly average)[a/]



a/ Nelson and Siegel method
Sources: Banco de la República

pressure from the exchange rate. Peso appreciation during the second quarter had a downward effect on the forecast for the tradable CPI in the coming quarters, including the forecast for imported foods. It also tempered the effect of higher international fuel prices on the regulated CPI.

With regard to the wage costs, the fact that wages have continued t o adjust at rates not much above the ceiling of the target range for inflation means these variables will not be a source of upward pressure on consumer prices during the rest of the year. In addition, the decline in health contributions from employers as of January 2013, pursuant to the 2012 tax reform, has reduced the actual costs of hiring manpower.

However, the employment gap, which is balanced at present, could enter negative terrain in 2015, if the unemployment rate continues to decline, as expected. In this case, added pressure on wages could emerge in 2015 and its impact could begin to affect prices.

As for non-labor costs, the increase in the international price of oil, compared to what was considered in the previous report, coupled with other circumstances such the rise in energy costs and prices for certain agricultural products in the coming quarters, could prompt increases that would be passed on to consumer prices. However, in this case, the pass-through of peso appreciation, as observed in the second quarter, would compensate for that fact.

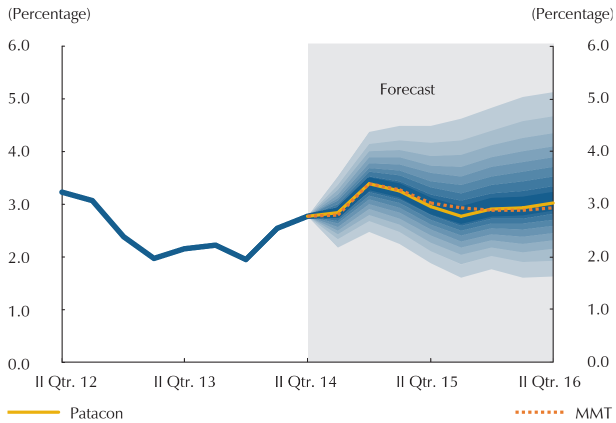
Considering the above, the Bank's models show increases in overall consumer inflation for the next two or three quarters, as was already explained. These are concentrated largely in food and regulated items; therefore, an important percentage can be regarded as temporary. However, to the extent these increases affect the expectations of agents in the market, they also have a long-term impact by increasing the inflation forecast in a more permanent way.

C. RISK BALANCE

The risk balance for inflation was biased upward in this report.

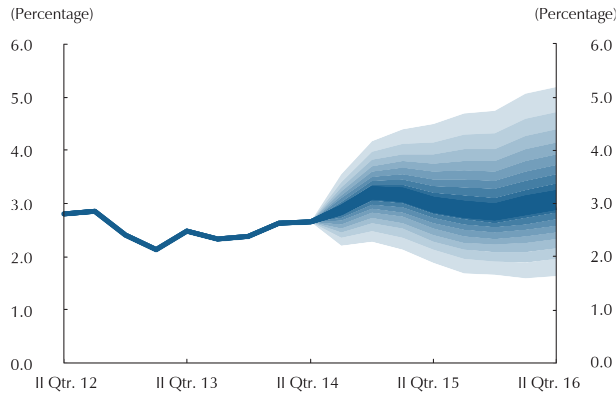
The risk balance estimated for overall consumer and non-food inflation is shown in the fan charts (Graphs 44 and 45). The uncertainty contemplated in this report is similar that of the previous report, although there is an upward bias in the confidence intervals compared to three months ago, when the balance was more even. This bias is can be attributed to several causes. One is possible pressure from the evolution in food prices and its impact on inflation expectations. Another is the possibility that the Federal Reserve will alter interest rates sooner than expected, which could have repercussions on capital flows and the exchange rate.

Graph 44
Total Inflation Fan Chart



Patacon: Policy Analysis Tool Applied to Colombian Needs
(Dynamic stochastic general equilibrium model)
Source: Banco de la República

Graph 45
Non-food Inflation Fan Chart



Source: Banco de la República.

The following are the main upward risks:

Major price increases for food produced in the country:

The climate changes that might occur during the remainder of this year and in part of 2015, due to *El Niño* weather, as well as changes in the conditions surrounding agricultural supply, pose the risk of a sharp hike in food prices that is more pronounced in this report than was the case last quarter. In recent months, there have been reports of an increase in the likelihood of *El Niño* weather. Although it would be moderate, in principle, yield in the agricultural sector would be affected if it does occur and could prompt postponements in planting, which would result in price increases for many foods. These hikes would occur between the fourth quarter of this year and the second quarter of 2015, and would be higher than those contemplated in the central forecast. Upward effects from shocks to production, amid continuation of the agricultural supply cycle, cannot be ruled out either. This takes into account products such as meat, where there has been a recent decline in slaughtering. This is particular to the retention phase, which could last for several quarters and lead to higher meat prices. These circumstances were not contemplated fully in the central forecast, given the complexity of determining the exact effect on prices. In principle, all these shocks are expected to be temporary. However, insofar as they influence expectations, their impact on inflation might be more lasting.

The assumption in this report is that the Fed will begin to raise its benchmark interest rate at the beginning of the second half of 2015.

More depreciation in the exchange rate than contemplated, if the Fed raises interest rates sooner than expected:

The assumption in this report is that the Fed will end its financial asset buying program this year, at the start of the fourth quarter, and would begin to raise the benchmark interest rate at the beginning of the second half of 2015. However, positive surprises from the growth and employment indicators in the second quarter, despite the poor figure in the first quarter, and several signals that indicate inflation could begin to rise faster than expected, suggest the Fed could anticipate its schedule for raising interest rates. If this were to happen, there is the risk of major changes in the capital flows to emerging economies, including Colombia, which could weaken the peso beyond what is contemplated in the central forecast. The Colombian economy is not decidedly vulnerable to an event of this type, given relatively low external imbalances and less dependence on foreign borrowing to finance them. However, the contagion that might pummel the sovereign risk premium, which would impact the stability of the exchange rate, cannot be ruled out.

If this were to occur, additional upward pressure would be brought to bear on the cost of commodities and imported foods, as well as on the price of tradables and regulated items in general. A more depreciated exchange rate would have upward effects on inflation in the basket of tradable goods and, therefore, on consumer inflation overall. These effects could be exacerbated to the extent that they last longer and inflation expectations are affected.

More domestic demand than anticipated in the central forecast for 2015:

By 2015, the rise in domestic demand might be more than is anticipated in the central forecast for inflation, due to added investment in civil works associated with the country's fourth-generation highway programs. In principle, these works will begin to affect growth as of next year, but given the difficulty in quantifying their impact, it might be underestimated in the baseline scenario of this report.

Although more investment in roads can lead to an increase in GDP growth potential, this does not happen in the initial stages of project implementation. At that point, added growth in demand likely will translate into a more positive output gap. This could generate upward pressures to the prices of non-tradables and on consumer inflation overall, beyond what is considered in the central forecast.

Added growth in demand will likely translate into a more positive output gap.

The following are some of the downside risks considered in this report.

In China, the situation with shadow banking continues to pose a significant downside risk to global growth.

Less growth in the emerging economies than contemplated in the central forecast:

The situation with the informal financial market in China continues to pose a significant downside risk to global growth, compared to what was estimated in the central forecast. Added to this is the recent possibility of less dynamic performance in China's real estate market and its investment in general. The latter is fundamental when it comes to identifying upward pressures on commodity prices. Weakening in China could adversely affect the economic growth of many of Colombia's trading partners through multiple channels, including terms of trade.

There is also the risk that economic performance in the Latin American countries will be poorer than anticipated. The countries that have registered setbacks already (Argentina and Venezuela) and others with very little growth (Brazil) are especially vulnerable; however, even economies that displayed outstanding performance in the past, such as Chile and Peru, face downside risks.

If these risks were to materialize, they would translate into weaker external demand, less investor and consumer confidence, and more of a decline in international commodity prices for Colombia. All this combined can lead to fewer exports and falling production costs, with downward consequences for consumer inflation that are not contemplated in the central forecast, provided these downward trends are not offset by possible pressure towards depreciation of the exchange rate.

Lower adjustments in the prices of some regulated services due to changes in regulations:

A reduction in garbage collection rates probably will be authorized in 2014 when the bill proposing new rates for the sector takes effect, as announced by the Ministry of Housing, City and Territory. More than 80% of the population in approximately 350 municipalities throughout the country will benefit from these rate cuts, which were not contemplated fully in the central forecast.[16]

The probability of total inflation being within the range of 2% to 4% in 2014 and 2015 is still high.

After weighing the various risks in the fan charts, it is possible to say the likelihood of total inflation being within the range of 2% to 4% in 2014 and 2015 is still high. It should be noted that the central forecast presented in this report assumes an active monetary policy, with interest rates that are adjusted to ensure compliance with the long-term target for inflation.

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16 See Resolution CRA 643/2013.

V. Risks to macroeconomic stability

The available data for 2014 show a widening of the deficit in the current account, appreciation in the real exchange rate, and acceleration in lending. Housing prices continue to post high growth.

The outlook for the Colombian economy remains positive. However, in the medium term, there is a risk of less favorable or adverse shocks that might affect national revenue or raise the cost of external financing. For this reason, potential vulnerabilities have to be monitored.

Following the international crisis in 2008, the figures on record for economic activity, inflation and the job market in Colombia have been quite favorable. In fact, between 2009 and so far in 2014, GDP grew 4.2% on average, inflation has been within the target range most of the time, hovering around 3%, and the unemployment rate has fallen to record low levels.

The good results for the Colombian economy occurred in a context where terms of trade were high

The good economic results during that period occurred in a context where terms of trade were high. These spurred national revenue, with broad external financing at historically low interest rates and high FDI, primarily for sectors such as mining, industry and commerce, among others.[17] Domestically, the pass-through has been dynamic, levels of household and business confidence have been favorable, and more financial depth has been achie-

17 Between 2009 and 2013, 56.5% of FDI went to mining, 11.1% to manufacturing, 10% to commerce, 8.9% in the financial sector, and 13.5% to other sectors.

Nevertheless, it is crucial to determine if there are signs that macroeconomic stability might be at risk.

ved. In this scenario, an active monetary policy has been crucial to keeping inflation near its target and helping to smooth output growth.

Even so, in a macro-prudential context it is necessary to look at how the other economic variables behave to determine if long-term macroeconomic stability might be at risk. There is evidence of developing economies in the past that experienced sharp increases in their terms of trade or capital inflows, with the subsequent effect on asset prices and aggregate demand being amplified by the financial system through a considerable build-up in lending. As a result, the current account deficit reached unsustainable levels, the real exchange rate appreciated, and asset prices posted excessive valuations, in some cases, because temporary improvements in income, the cost of financing or wealth were perceived as permanent. Then, when terms of trade and capital flows returned to normal, the adjustment in these economies was chaotic and they faced heavy costs in terms of employment, growth and well-being. Continuously monitoring certain economic variables serves to detect momentum that deviates from long-term trends and, therefore, is crucial to implementing action deemed appropriate to ensure macroeconomic stability.

In this respect, although the outlook for the Colombian economy remains positive, there is a risk of less favorable or adverse shocks in the medium term, such as deterioration in national revenue or an increase in the cost of external financing. Given these risks, it is necessary to monitor possible vulnerabilities such as excessive domestic or external leveraging or other imbalances that could place the country's macroeconomic stability at risk.

Accordingly, this section includes a description of how the current account, the real exchange rate, and lending and housing prices have performed. Possible imbalances are estimated for these variables, along with an indicator of macroeconomic imbalances (IDM).[18]

The current account deficit was 4.6% of GDP In the first quarter of 2014, having increased compared to the same period in 2013 (3.6%).

A. THE CURRENT ACCOUNT AND THE REAL EXCHANGE RATE

The figures for the balance of payments point to an increase in the current account deficit, which rose from 3.6% of GDP in the first quarter of 2013 to 4.6% of GDP during the same period this year. As explained in Chapter I, this outcome was generated mostly by deterioration in the trade balance in goods, given fewer exports and more imports (Graph 46).

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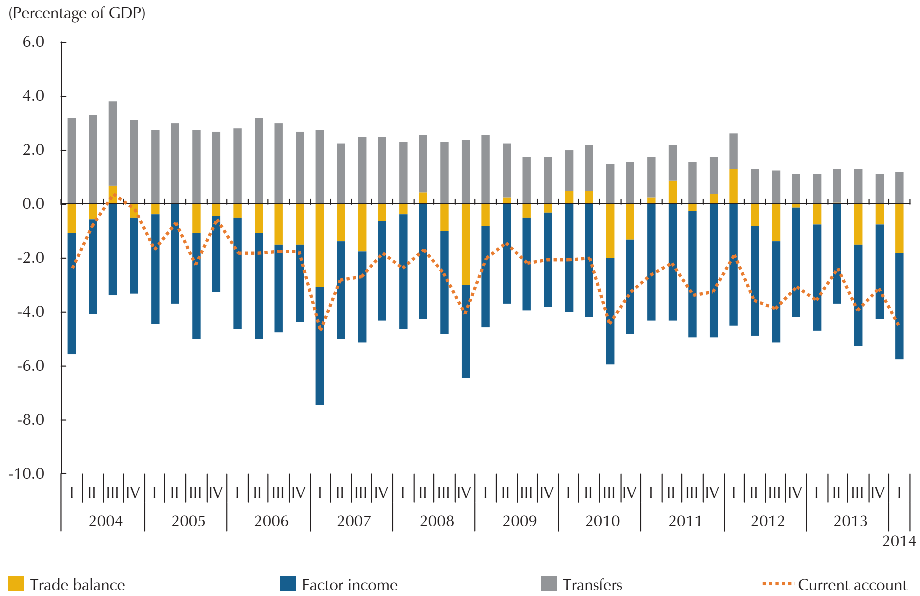
18 See C. Arteaga, C. Huertas y S. Olarte (2012). "Índice de desbalance macroeconómico", *Borradores de Economía*, no. 744, Banco de la República.

Graph 46
Current Account



Observation: The data are presented pursuant to the recommendations in the sixth edition of the Balance of Payments Manual proposed by the IMF.
For additional information and methodological changes, go to http://www.banrep.gov.co/balanza-payments
Source: Banco de la República

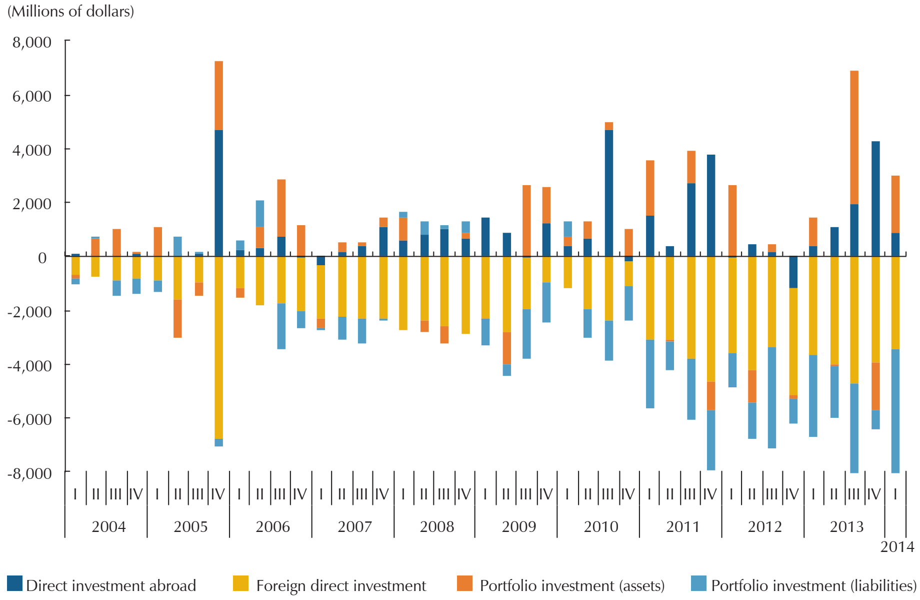
Part of the expansion in the trade deficit in dollars during the first quarter was due to circumstantial factors. One example is the decline in coal exports as a result of the adjustments required to comply with environmental regulations. Other factors include the closure of the Cartagena refinery, which caused an increase in gasoline imports and fewer exports of refined products, and the attacks on the country's oil infrastructure, which reduced the supply of exportable oil.

As for the financial account, the balance of payments between January and March 2014 showed inflows that exceeded the value of the current account deficit, as generally has been the case throughout the last decade. However, this time, the share of direct investment was similar to share of portfolio investment. In relative terms, this means the importance of funding with portfolio resources increased in the margin and that of FDI declined. Even so, a look at the total value of foreign liabilities relative to GDP (64% in March 2014) shows that more than half are FDI (35%) and only 15% pertain to portfolio investment.

Capital inflows exceeded the value of the current account deficit, as generally has been the case throughout the last decade.

It is noteworthy that net flows also include a considerable amount of foreign assets constituted by Colombians, in addition to the increase in international reserves. The latter, besides mitigating the impact of foreign flows, may be a mechanism for softening possible negative shocks from external financing (Graph 47).

Graph 47
Direct and Portfolio Investment



Observation: According to the sixth edition of the Balance of Payments Manual proposed by the IMF, the financial account is presented with the same sign as the current account. Therefore, asset flows (accumulation of assets abroad) are presented with a plus sign and liabilities with a minus sign.
For additional information and methodological changes go to http://www.banrep.gov.co/balanza-payments
Source: Banco de la República.

The indicators available for the second quarter of 2014 show that the trade deficit persisted and portfolio inflows increased. In fact, export value in April and May was less than import value during the same period. JP Morgan's announcement that it is including a larger share of Colombian government bonds in the portfolio of two of its indexes[19] generated flows of foreign capital into the country on the part of funds that replicate these indices and those that see this as a positive sign for Colombia. These portfolios are expected to be fully rebalanced by September of this year.

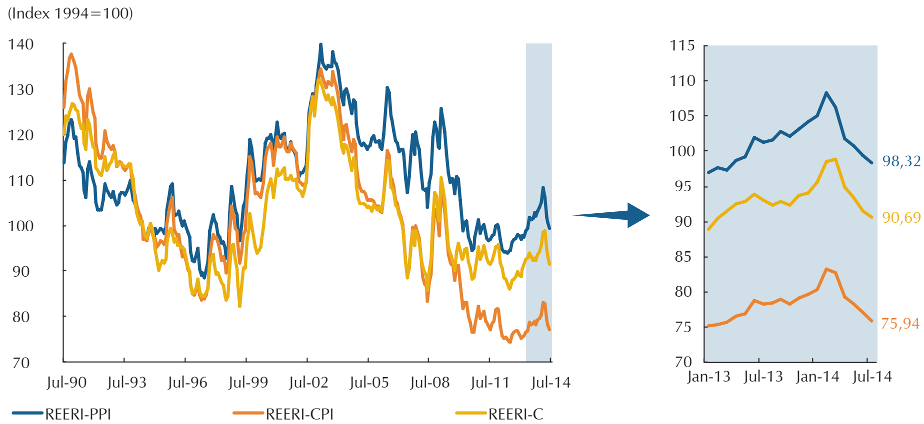
These inflows explain part of the nominal and real appreciation observed in the second quarter.

These capital inflows explained part of the nominal and real appreciation observed in the second quarter of 2014. During that period, the exchange rate appreciated 4.7%, on average, compared to the year before. The real exchange rate (RER), which trended upward between July 2012 and February 2014, reversed and was at levels, in July 2014, similar to those recorded in the first half of 2013 (Graph 48).

The structural changes in the RER can be explained by the behavior of several key variables that guide long-term movement in this indicator. For

19 For a detailed explanation, see *Reportes del Emisor*, no. 179, "Análisis del impacto en Colombia de la recomposición de los índices de JP Morgan de deuda local de países emergentes," April 2014.

Graph 48
Real Effective Exchange Rate Indexes



Source: Banco de la República

example, the added momentum in spending on non-tradable goods and services in the economy has led to higher price increases in this sector than for tradables and has exerted downward pressure on the RER. In contrast, other fundamentals related to the external situation, such as lower terms of trade and the payment of higher returns associated with deterioration in the international investment position, continue to press upward.

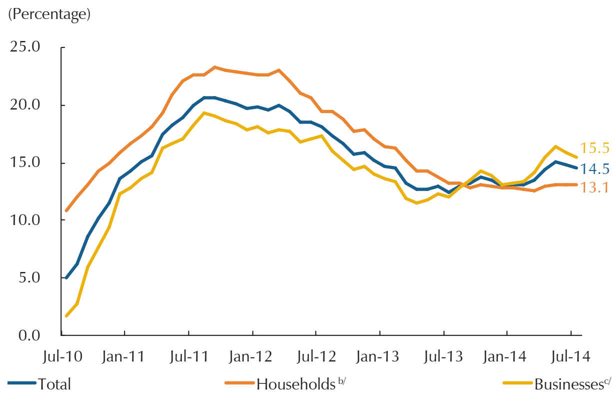
As for the current account, there are elements that determine its long-term trend and could be affecting the country's external balance from a structural perspective. One is the international momentum in commodity markets, which suggests a general decline in prices in the medium term, as was observed already for products such as coal and gold. As for oil, there is uncertainty about its price in the medium term. A significant reduction in the prices of commodities exported by Colombia would imply further deterioration in the trade balance. The second factor is a slow recovery in external demand that is relevant for Colombia. The third is the behavior of transfers for factor income, especially those generated by foreign firms that produce non-tradable goods and services and have no income in foreign currency (see Box 1: "Earnings of Foreign Companies in Colombia: Sector Dynamics and Prospects," pp. xx). Finally, the increase in domestic demand, beyond the rise in output, continues to generate added needs for external purchases, particularly due to the growth in spending on consumer durables, transport goods, and machinery and equipment.

The loan portfolio in pesos accelerated during the second quarter and grew at annual rates between 14% and 15%.

B. INDEBTEDNESS

The loan portfolio in pesos accelerated during the second quarter of 2014 and grew at annual rates between 14% and 15%, surpassing the increase in nominal GDP. This added momentum was led by the performance of com-

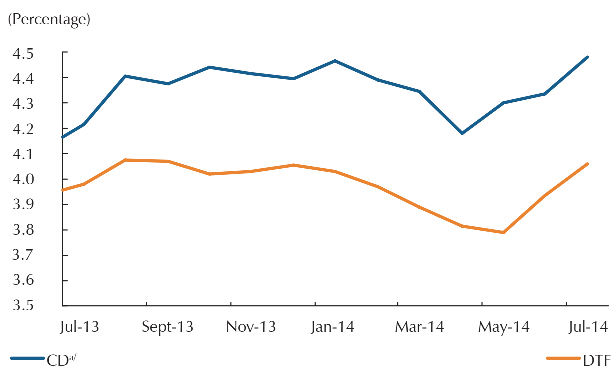
Gráfico 49
Loan Portfolio in Domestic Currency[a/]
(Annual change)



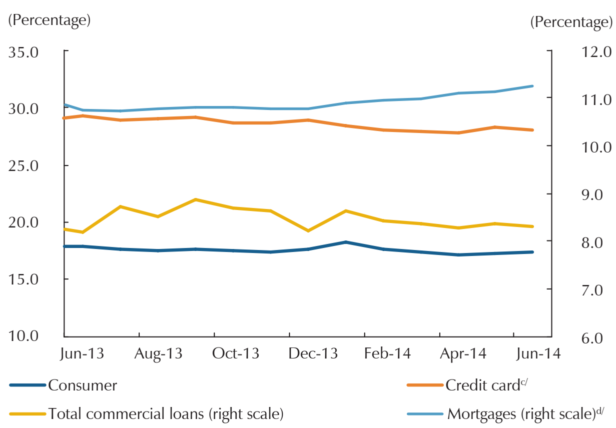
a / Includes financial leases and mortgage loan securitization. Excludes transactions related to the sale of loan portfolios for management through trust rights.
b / The sum of consumer and mortgage loans (with securitizations)
c / The sum of the commercial and micro-loans
Source: Financial Superintendence of Colombia, Banco de la República. calculations

Graph 50
Nominal Interest Rates

A. Deposit Rates



B. Lending Rates[b/]



a / Monthly average weighted by amount of the interest rate CDs at all maturities
b / Monthly average weighted by amount.
c / Does not include advances or consumption at one month.
d / Refers to the rate to acquire non-low income housing.
Source: Financial Superintendence of Colombia; Banco de la República calculations

mercial loans, which account for roughly 60% of the credit portfolio. Loans to households grew at relatively stable rates, with increases of around 12% annually for consumer lending and 16% for mortgages (including securitization) (Graph 49). Significantly, the growth rates for all loans, except home mortgage loans, had declined by the end of last year.

Lending institutions have financed the increase in the loan portfolio (about $ 12.7 t between March and June 2014) by reducing investments in local currency (about $ 10.0 t), mostly in TES. The buyers for those securities were foreign funds, which increased their holdings from 7% of total TES in January of this year to 13% in July.

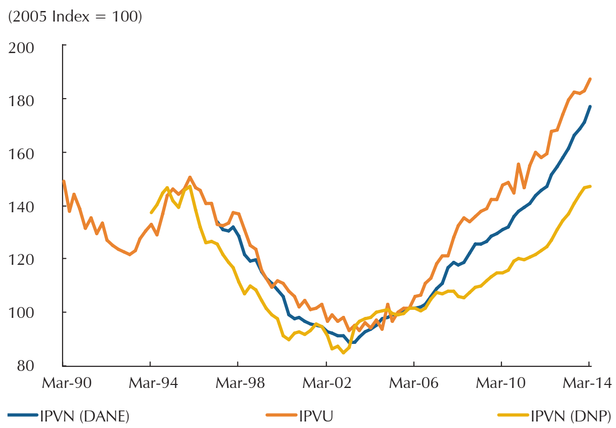
The behavior of interest rates suggests the growth in lending was more a question of increased supply than demand. As shown in Graph 50, nominal interest rates on loans remained relatively stable during the second quarter (and even dropped in real terms), while nominal rates on deposits increased. It also is worth noting that the March edition of *The Survey on Lending in Colombia* showed financial intermediaries perceived less demand for all types of loans, except home mortgage loans.

The cost of borrowing is expected to rise during the remainder of the year, which should help to moderate the speed and extent of household and business debt. In effect, the benchmark interest rate hike should have passed through to interest rates on loans. On the other hand, although the June edition of *The Survey on Lending in Colombia* shows loan applications have increased, any additional expansion in the portfolio probably will be financed largely through an increase in liabilities, which would exert upward pressure on interest rates. This takes into account the low ratio of investments to the loan portfolio, and the need for lending establishments to maintain appropriate amounts in TES on their balance sheets in order to access repos with Banco de la República or as collateral on the interbank market.

As mentioned in earlier reports, private sector borrowing is high compared to its historical average. Yet, even so, the financial burden has remained low, thanks to interest rate levels. In this context, higher lending costs would help to slow borrowing in the private sector.

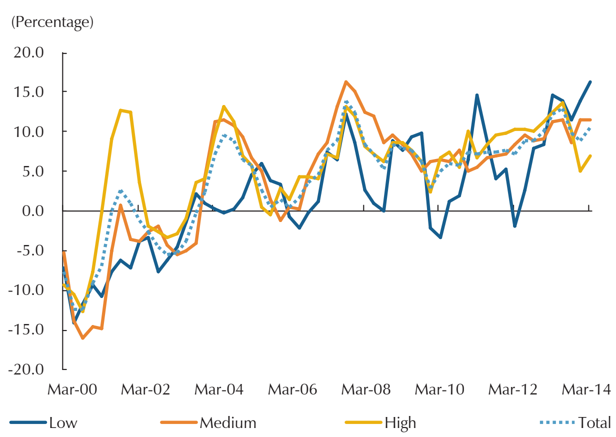
In terms of credit risk, economic conditions so far this year have been good. Even so, there has been marginal deterioration in the delinquency and quality indicators for all types of loans. While these indicators are still historically low (except for micro-loans), there is the risk that an adverse shock, such as a significant rise in the unemployment rate, might impact family income and undermine the health of the financial system.

Graph 51
Housing Prices Relative to the CPI



Source: DANE, DNP and Banco de la República

Graph 52
New Housing Price Index for Bogota (Relative to the CPI), by Socioeconomic Bracket
(Annual change)



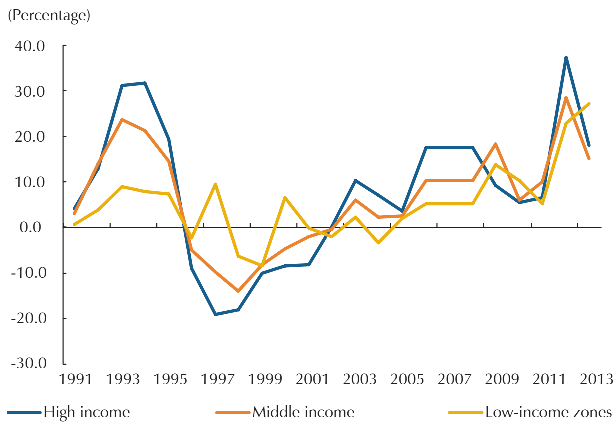
Source: DANE, Banco de la República calculations

C. HOUSING PRICES

The housing prices indexes (relative to the CPI) continued to grow at significant rates during the first quarter of 2014, posting new record highs (Graph 51). However, the signal sent by the build-up in housing prices is unclear. On one hand, the new housing price index (IPVN) nationwide rose 9.8%, which is more than the rate observed in the fourth quarter of 2013. In contrast, the existing housing price index (IPVU) calculated by *Banco de la República* points to 4.4% growth; that is, 0.7 percentage points less than the last figure in 2013.

Housing price hikes have been widespread in the major cities. However, unlike previous quarters, the figures reflect higher increases in the price of housing for low-income families than for segments of the population with more purchasing power. In the case of Bogotá (Graph 52), the added momentum in low-income housing (LIH) and the limited supply of land for urban development have pushed up land prices in low-income areas. In 2013, the value of land for residential development in these sectors rose 27.1% above inflation, 12 percentage points more than land in middle-income areas and 9 percentage points more than land in high-income areas (Graph 53). Accordingly, the average increase in the price of residential land in Bogota was 17.9%. All this momentum has occurred in the context of a go-

Graph 53
Annual Change in the Price of Residential Land (Relative to the CPI[a/]), by Zones



a/ Total CPI for Bogota
Source: Lonja de Bogota, Banco de la República calculations

vernment policy to encourage low-income housing projects.

As for the non-LIH segments, the interest rate hikes observed in the home mortgage portfolio, coupled with marginal deterioration on their quality and delinquency indicators, could slow the growth in lending for home purchase and help to mitigate price increases in the coming quarters. Similarly, insofar as monetary conditions in the developed countries return to normal, particularly in the United States, other types of investments could become more attractive.

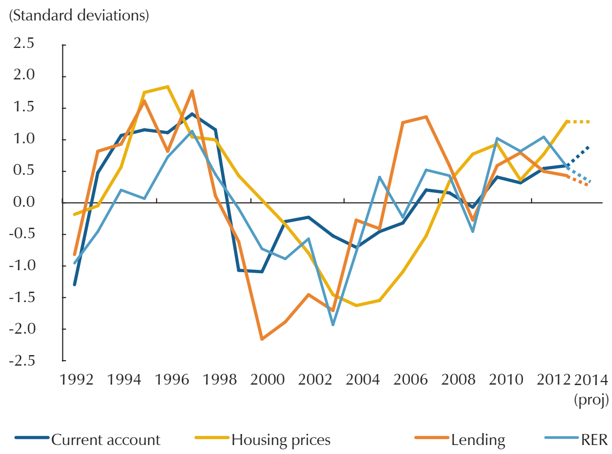
D. LONG-TERM ESTIMATES AND THE MACROECONOMIC IMBALANCE INDEX

The evolution of the variables described above indicates the current account deficit has grown, the RER has appreciated and returned to levels similar to those witnessed in the first half of 2013, lending has accelerated once again, and housing prices continued to increase significantly. This performance suggests an expansion in the aggregate imbalance, provided the dynamics of these variables are not determined by the behavior of their fundamentals.

Estimates for 2014 developed by the technical staff of Banco de la República indicate an increase in the imbalance[20] in all these variables, except lending, compared to the information from the previous *Inflation Report.* Specifically, the gaps forecast for the current account and the RER increased. In the first case, although a larger deficit is expected compared to the one in 2013, the figure for the first quarter was higher than the one projected by the fundamentals. As for the RER, part of the real appreciation is explained by the better-than-expected momentum in domestic demand, coupled with the behavior of risk premiums. However, the determinants related to the external sector (terms of trade or the deterioration in net foreign assets) suggest a different direction. As for housing prices, although the gap widened to a lesser extent, it gained share in the aggregate indicator. The imbalance estimated in lending continued (Graph 54).

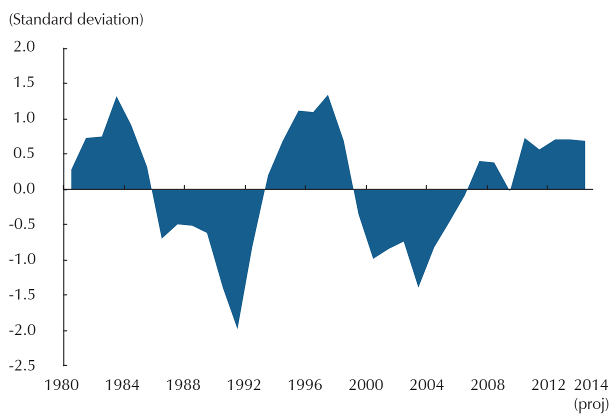
20 Positive values indicate an imbalance. For the RER, this is calculated as the long-term level minus the actual value.

Graph 54
Current Account, Real Interest Rate, Housing Prices and Lending Gaps



Source: Banco de la República

Graph 55
Macroeconomic Imbalance Index (IDM)



Source: Banco de la República

With all this, the macroeconomic imbalance index (IDM) suggests the estimated imbalance would be similar in 2014 to what it was in 2013, and the main sources of vulnerability would be related to the external sector (Graph 55). In this context, a slowdown in absorption would generate less pressure towards deterioration in the current account and appreciation of the RER. The risk in the future is that a sharp drop in terms for international financing or a sizeable decline in terms of trade might produce a quick adjustment in the current account and a sharp contraction in domestic demand, with the negative implications this would have for the income and well-being of the population.

Attachment

Macroeconomic forecasts by local and foreign analysts

The latest forecasts by local and foreign analysts with respect to the major variables in the economy for 2014 and 2015 are summarized in this section. At the time they were consulted, the analysts had data up to July 2014.

Forecasts for 2014

The local analysts expected 4.8% economic growth, on average, which is above the estimate in the previous edition of the *Inflation Report*. The foreign agencies that were consulted expect GDP growth to average 5%.

Table A1
Macroeconomic Forecasts by Local and Foreign Analysts for 2014

	Real GDP Growth	CPI Inflation	Nominal exchange rate end of:	Nominal DTF (Percentage)	Fiscal deficit (Percentage of GDP)	Unemployment Rate in the Thirteen Main Cities (Percentage)
	(Percentage)					
Local Analysts						
Alianza Valores	5.0	3.4	2,050	5.1	n. d.	n. d.
Anif [a/]	4.6	3.2	n. d.	5.1	2.4	8.1
Banco de Bogotá	5.0	3.1	1,915	5.0	2.4	9.4
Bancolombia [a/]	4.7	3.1	1,955	4.75	2.4	8.5
BBVA Colombia [a/]	4.7	3.5	1,960	4.6	2.4	10.0
BGT Pactual	4.8	3.3	2,010	n. d.	2.4	9.0
Corficolombiana	5.0	3.2	1,875	5.2	1.6	8.8
Corpbanca [b/, c/]	5.2	3.3	1,980	5.00	2.4	8.4
Corredores Asociados [a/]	5.1	3.4	1,950	4.5	2.4	n. d.
Correval	5.0	3.4	1,950	5.3	1.4	9.1
Davivienda [a/]	4.6	3.4	1,900	4.4	2.4	8.5
Fedesarrollo [a/]	4.3	3.3	1,896	4.80	2.3	9.2
Ultrabursátiles	4.7	3.1	1,930	4.4	n. d.	9.0
Average	**4.8**	**3.3**	**1,947.6**	**4.8**	**2.2**	**8.9**
Foreign Analysts						
Citi	5.0	3.4	1,930	4.80	2.4	9.0
Deutsche Bank	4.6	3.3	1,890	n. d.	2.3	n. d.
Goldman Sachs	5.3	3.0	1,950	n. d.	2.3	n. d.
JP Morgan	5.0	3.2	n. d.	n. d.	1.2	n. d.
Average	**5.0**	**3.2**	**1,923.3**	**4.8**	**2.1**	**9.0**

n, d,: Not available
a/ The projected deficit pertains to the national government
b/ Average unemployment rate for the year
c/ Formerly Banco Santander
Source: Banco de la República (electronic survey)

Table A2
Macroeconomic Forecasts by Local and Foreign Analysts for 2015

	Real GDP Growth	CPI Inflation	Nominal Exchange Rate End of:
	(Percentage)		
Local Analysts			
Alianza Valores	4.5	3.6	2,200
Anif	4.5	3.0	n. d.
Banco de Bogotá	5.0	3.0	1,975
Bancolombia	4.5	3.4	2,100
BBVA Colombia	4.8	3.4	2,000
BGT Pactual	4.5	3.3	2,100
Corficolombiana	5.0	3.0	1,975
Corpbanca [a/]	5.3	3.3	2,100
Corredores Asociados	4.7	3.2	2,015
Correval	5.3	3.1	1,950
Davivienda	4.7	3.4	n. d.
Fedesarrollo	4.9	3.5	1,947
Ultrabursátiles	4.5	3.0	2,000
Average	**4.8**	**3.2**	**2,032.9**
Foreign Analysts			
Citi	5.5	3.5	2,000
Deutsche Bank	4.5	3.5	n. d.
Goldman Sachs	4.3	3.0	1,994
JP Morgan	4.5	3.0	n. d.
Average	**4.7**	**3.3**	**1,997.0**

n, d,: not available
a/ Formerly Banco Santander
Source: Banco de la República (electronic survey)

As to price level, the local analysts expect 3.3% inflation, while the foreign analysts forecast an increase of 3.2% in prices by the end of the year. These values are within the target range set by the Board of Directors of *Banco de la República* (BDBR) for 2014 (between 2.0% and 4.0%).

In terms of the exchange rate, local analysts expect the representative market exchange rate to average $1,948 by the end of the year, compared to $1,990 estimated in the survey contemplated in the previous edition of this report. The foreign analysts expect the exchange rate to be near $1,923 by the end of the year.

With respect to the rate on time deposits (DTF), local analysts forecast 4.8%, on average. They also expect the unemployment rate to be 8.9%.

Forecasts for 2015

Local analysts forecast 4.8% growth in 2015; the foreign analysts expect 4.7%. As for inflation, both local and foreign analysts are forecasting 3.2% and 3.3%, respectively. In terms of the exchange rate, the local and foreign entities expect it to average $2,033 and $1,997, respectively.

This Report was coordinated, edited and designed by the Publishing Division of the Administrative Services Department, using font Times New Roman 11.5. Banco de la República.

Published by Nomos.

September 2014