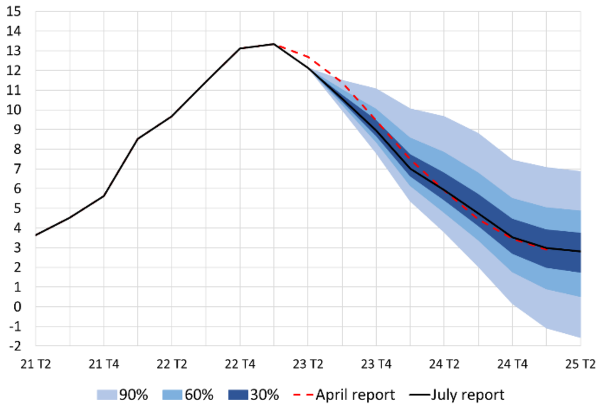
1. Summary

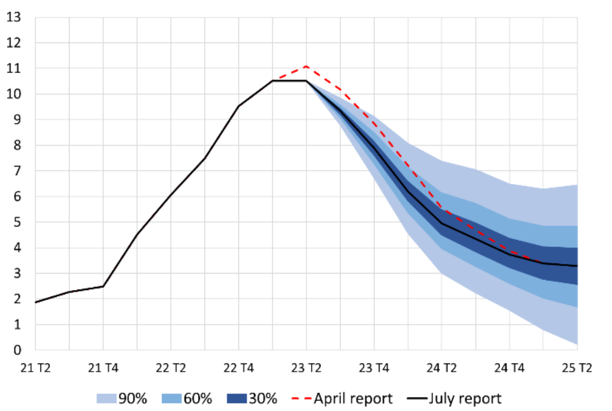
1.1 Macroeconomic Summary

Graph 1.1
Consumer Price Index [a/b/]
(annual change; end-of-period)
(percentage)



a/ This graph presents the forecast probability distribution on an eight-quarter time horizon. Density characterizes the prospective balance of risks with areas of 30%, 60%, and 90% probability surrounding the central forecast (mode), through a combination of densities from the Patacon and the 4GM monetary policy models.
b/ The probability distribution corresponds to the forecast exercise from the *July report*.
Source: DANE – calculations and projections by Banco de la República.

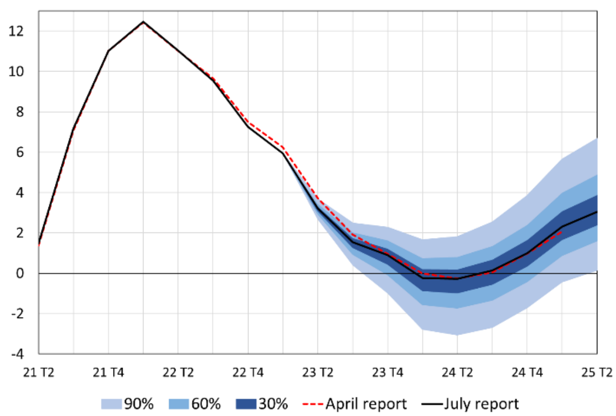
Graph 1.2
CPI excluding food and regulated items [a/b/]
(annual change; end-of-period)
(percentage)



a/ This graph presents the forecast probability distribution on an eight-quarter time horizon. Density characterizes the prospective balance of risks with areas of 30%, 60%, and 90% probability surrounding the central forecast (mode), through a combination of densities from the Patacon and the 4GM monetary policy models.
b/ The probability distribution corresponds to the forecast exercise from the *July report*.
Source: DANE – calculations and projections by Banco de la República.

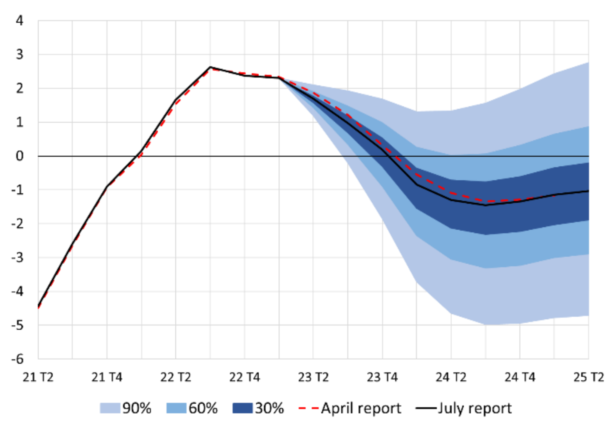
In the second quarter of 2023, total annual inflation fell to 12.1% and the rise of core inflation halted and stood at 10.5%; both measures were lower than those forecasted in the April Report but remained well above the 3% target. The aggregate effects of monetary policy actions and the unwinding of certain shocks that affected prices will contribute towards bringing inflation closer to the target in 2024. By component, the annual variations in the CPI for food and the CPI excluding food and regulated items have lessened more markedly than anticipated by the Central Bank's technical staff, underlying the decline in annual inflation. However, prices of regulated items and services continued to rise, nonetheless at a slower pace than expected, particularly in the case of services. For these two groups, price indexation mechanisms have resulted in the transmission of some transitory increases in certain CPI sub-components (e.g., food) to other items (e.g., rents, utilities, etc.), thus generating a greater persistence of already high inflation. This is acerbated by the gasoline price increases required to correct the deficit of the Fuel Price Stabilization Fund (*Fondo de Estabilización de los Precios de los Combustibles*, FEPC). Consequently, the CPI for regulated items forecast increased going forward relative to the April Report given the higher gasoline price adjustments announced by the Government. For the remaining items (food, goods, and services), the forecasted trajectory declined due partly to the lower-than-estimated inflation, a more notable reduction in the international prices of some food items and freight costs, lower exchange rate and cost pressures on prices, and a faster than anticipated decrease in excess demand. This occurs in a contractionary monetary policy environment that aims to reduce inflation towards rates close to the 3% target by the end of 2024. Against this background, headline inflation for yearend 2023 is forecast at 9% (formerly 9.5%) and 3.5% for yearend 2024 (previously 3.4%) (Graph 1.1). In the same timeframes, the core inflation forecast has been revised downward from 8.9% to 7.9%, and from 3.9% to 3.7%, respectively (Graph 1.2). These projections are subject to high uncertainty, especially surrounding future behavior of international financing conditions and the exchange rate, fluctuations in domestic demand, the possible occurrence of the *El Niño* natural climate phenomenon, and future decisions regarding domestic fuel and electricity prices.

Graph 1.3
Gross Domestic Product, four quarter accumulation [b/c/]
(annual change)
(percentage)



a/ Seasonally adjusted and corrected for calendar effects.
b/ This graph presents the forecast probability distribution on an eight-quarter time horizon. Density characterizes the prospective balance of risks with areas of 30%, 60%, and 90% probability surrounding the central forecast (mode), through a combination of densities from the Patacon and the 4GM monetary policy models.
c/ The probability distribution corresponds to the forecast exercise from the *July report*.
Source: Banco de la República

Graph 1.4
Output gap [a/b/c/] - Predictive Densities
(four-quarter accumulation)
(percentage)



a/ The historical output gap estimate is calculated as the difference between observed GDP (four-quarter accumulation) and potential GDP (trend; four-quarter accumulation) based on the 4GM model.
b/ This graph presents the forecast probability distribution on an eight-quarter time horizon. Density characterizes the prospective balance of risks with areas of 30%, 60%, and 90% probability surrounding the central forecast (mode), through a combination of densities from the Patacon and the 4GM monetary policy models.
c/ The probability distribution corresponds to the forecast exercise from the *July report*.
Source: Banco de la República

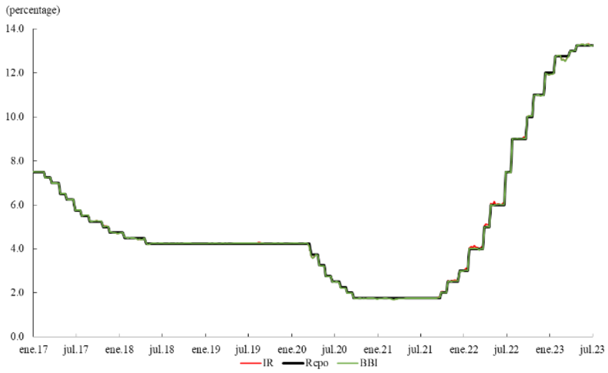
Economic activity is expected to decelerate at a slightly faster pace than projected in the April Report. The adjustment in domestic demand is anticipated to continue and converge by the end of the year to levels more compatible with the economy's productive capacity. In the first quarter, the seasonally and calendar-adjusted GDP rose by 3.0% on an annual basis. Annual domestic demand contracted due to the poor performance of investments, particularly a drop in machinery and equipment investments. Private consumption growth continued at a moderate pace. This was captured in the significant curtailing of imports, which, together with improved export dynamics - mainly of services - explains a reduction in the real external deficit. For the second quarter, the set of available indicators including the economic tracking index, retail sales, and consumer confidence and credit, suggest a quarterly decline in the levels of economic activity. The revised estimate places annual growth in the second quarter at 0.7%, indicating a quarterly decline in GDP, albeit from the historic high reached in the first quarter. This fall would be mainly attributed to a new decline in investments, while consumption would remain at a level comparable to that observed in the first quarter, though exhibiting a slight year-on-year reduction. In annual terms, exports would fall, yet by a smaller percentage drop than that seen for imports. Weak external demand is expected for the remainder of 2023 amid a backdrop of tight global financial conditions, coupled with lower terms of trade than those noted in 2022. Domestic demand would continue to adjust toward more sustainable rates in an environment of low consumer and business confidence levels, high household indebtedness, and a contractionary monetary policy compatible with a future convergence of inflation to its target. Accordingly, annual growth for 2023 would reach 0.9%, slightly lower than the 1.0% figure forecast for 2024 (Graph 1.3). Excess demand, measured through the output gap, would fade towards the end of 2023 and turn negative in 2024 (Graph 1.4). These estimates remain subject to a high degree of uncertainty owing to external factors such as global political tensions and monetary policy decisions in advanced economies, and domestic factors that include uncertainty regarding the course and impact of the reform proposals presented to Congress, the response of domestic demand to national financial conditions, and the increase in the fiscal deficit expected for 2024, among others.

The anticipated adjustment in domestic demand will contribute to narrowing the country's external imbalance. In 2022, strong growth in domestic demand that exceeded the economy's productive capacity largely explained the substantial current account deficit (6.2% of GDP). By 2023, lower domestic demand, consistent with long-term sustainable output levels and the convergence of inflation to the target, would also assist in reducing the external imbalance. Therefore, in 2023, the current account deficit would drop to 4.0% of GDP, mainly owing to a decline in imports from the high levels recorded in 2022, and lower profits remitted abroad by companies with foreign capital. Although the current account deficit would remain high, the reduction of the external imbalance would make the Colombian economy less vulnerable to significant deteriorations in the global framework.

External financial conditions are expected to remain tight in a context of high - albeit declining - global inflation and a slowdown of the global economy. Nevertheless, there have been general improvements in the risk perception of emerging economies, including Colombia. The supply and cost shocks that affected prices in the global environment continue to ease, resulting in lower international food and fuel prices. However, headline and core inflation continue to exceed their targets across most countries. In addition, the renewal of blockades by Russia on Ukrainian exports would again place upward pressure on international food prices. External demand continues to slow against a backdrop of high international interest rates. Lower global growth prospects, alongside improvements in oil supply, led to a decline in the observed and projected price of Brent. In the United States, the Federal Reserve (Fed) increased the federal funds rate to a target ranging between 5.25% and 5.50%, and it is likely that, given the persistence of high core inflation and a tight labor market, there will be a further hike during the remainder of this year. Meanwhile, the sovereign risk premiums of some emerging economies have declined, and their currencies appreciated. The steeper cost of global financing and the loss of real income due to higher levels of global inflation, among other factors, will continue to impact the world economy and indicate a slowdown in external demand germane to Colombia. In turn, the expected deterioration of the terms of trade would negatively affect national income. Uncertainty surrounding external forecasts and their impact on the country remains high given the unpredictability of the war in Ukraine, geopolitical tensions, the tightening of external financial conditions, and the effect of internal reforms on Colombia's sovereign risk perception, among others.

The macroeconomic context suggests that a contractionary monetary policy should continue in order to bring inflation back toward the target and contribute to returning aggregate demand to levels compatible with the economy's productive capacity and a sustainable external position. Economic activity indicators for the second quarter show that the economic slowdown could be more pronounced than that projected in the April Report. However, the output level continues to exceed the economy's productive capacity, the labor market exhibits the lowest unemployment levels of the past four years, and the current account deficit remains high despite its recent drop. A worsening of the banking loan portfolio is noted, but the Colombian financial system maintains adequate provisions, solvency, and liquidity levels that would allow it to face significant macroeconomic declines. Concerning price levels, headline inflation decreased in the second quarter while core inflation stagnated, yet they both continue to manifest rates well above the target. The faster-than-expected decline in inflation has occurred within a backdrop of dissipating external and domestic supply shocks previously elevating prices and production costs, a significant appreciation of the peso, and a marked cumulative adjustment of domestic financial conditions. For the remainder of 2023, the downward inflationary trend is expected to continue in an environment of lessening exchange rate pressures on prices as supply shocks continue to fade, albeit as domestic fuel prices face greater increases. As such, the technical staff reduced their headline and core inflation forecast for 2023 yet expect levels still above 3% and continue its convergence towards the target by yearend 2024. Inflation expectations for the end of this year and two-year ahead expectations have moderated but remain above 3%. The macroeconomic context, characterized by high inflation with forecasts and expectations above the target, as well as continuing excess demand, requires maintaining a contractionary monetary policy that seeks to meet the inflation target by yearend 2024 and achieve sustainable output levels. This contractionary monetary policy, in a setting of positive financial soundness indicators, does not suggest a trade-off between price stability and safeguarding financial stability.

Graph 1.5
Monetary policy interest rate, interbank rate and BBI/
(weekly data)



Sources: Superintendencia Financiera de Colombia and Banco de la República.
1/ IR: interbank rate. BBI: benchmark banking indicator.

1.2 Monetary Policy Decision

At its June and July 2023 meetings, the Board of Directors of *Banco de la República* (BDBR) voted unanimously to maintain the monetary policy interest rate unchanged at 13.25% (Graph 1.5).