Inflation Developments and Monetary Policy Decisions

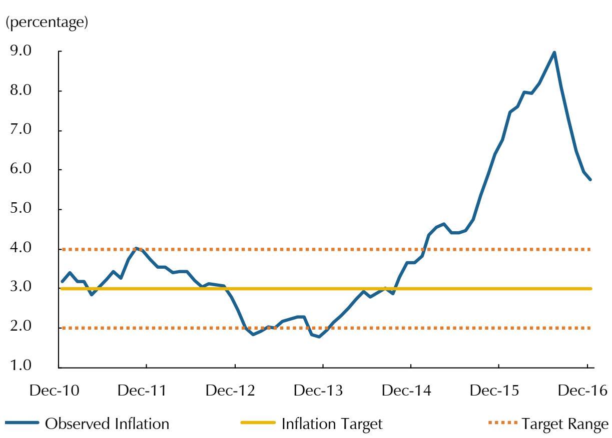
Annual inflation in December fell for the fifth consecutive month, standing at 5.75%, still exceeding the 3.0% target (Graph A). Something similar happened with core inflation indicators and inflation expectations. Also, the slowdown of the food CPI continued, although at a slower pace than expected, as did that for the prices of goods and services which were most impacted by the past strong nominal exchange rate depreciation.

The average of inflation expectations, which reached its highest level in July 2016 (6.61%), stood at 5.6% in December. Some alternative indicators increased, all surpassing the 3.0% target: analysts' inflation expectations to one and two years posted at 4.25% and 3.59%, respectively, and those implicit in public debt bonds to 2, 3, and 5 years increased, posting between 3.8% and 4.8%.

The effects of strong transitory supply shocks (*El Niño* and nominal depreciation), which diverted inflation from its target, are expected to continue fading. This, together with the monetary policy decisions taken so far, should lead inflation to its target range in 2017 (3.0% ±1 pp).

Regarding economic activity, the new figures for the fourth quarter of 2016 suggest that economic growth would have been low, although somewhat higher than in the third quarter. Consequently, the technical staff reduced the growth forecast for 2016 from 2.0% to 1.8%, within a range between 1.6% and 2.0%. Partly as a result of the slowdown, it is estimated that the current account deficit would have been somewhat lower than forecast one quarter ago, posting between 4.3% and 4.7% of GDP, with 4.5% as the most likely figure.

Graph A
Total Consumer Inflation



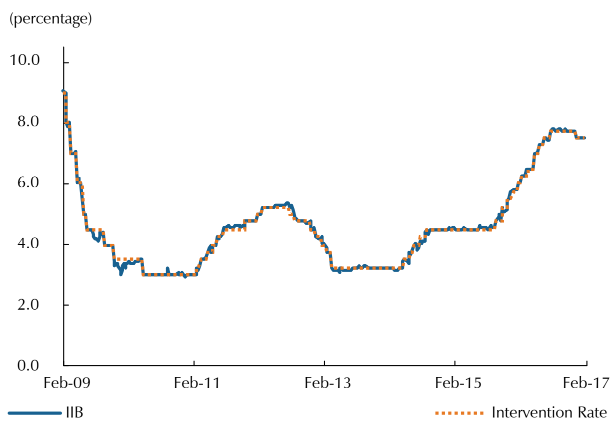
Sources: DANE and Banco de la República.

For 2017, recovery of external demand and the country's terms of trade is expected, within a very uncertain international context. Domestic demand will remain weak, although somewhat stronger than the one recorded in 2016, mainly due to the behavior of investment. With this, the technical staff at the Central Bank forecasts that economic growth will stand between 0.7% and 2.7%, with 2.0% as the most likely figure. This forecast is situated in the lower part of the range projected by the market.

The slowdown of output and the lower external imbalance in 2016 reflect the needed adjustment of the whole economy to the negative shock to national income that the country has been facing since mid 2014. The inflation targeting strategy, which aims to maintain a low and stable increase of consumer prices with inflation expectations anchored to the target, represents an important feature for economic growth sustainability. Returning to higher and sustainable rates of economic growth requires structural reforms in the economy, which do not only depend on the Central Bank, but mainly on the Colombians' savings and investment decisions, as well as on structural reforms implemented by the government.

In all, the Colombian economy continues to adjust to the strong shocks recorded since 2014, and the current account deficit continues to adjust. Output dynamics has been weaker than forecast, inflation has decelerated, and the effects of several of the transitory supply shocks that have affected inflation and inflation expectations continue to reverse, and this trend is likely to continue. However, the reversal of core inflation has been slower than that of headline inflation, and some inflation expectations increased, all of them exceeding the 3.0% target.

Graph B
Banco de la República's Intervention Rate and the Overnight Rate (OR)
(2009-2017)[a/]



a/ The figures pertain to working days. The last figure is for February 16, 2017.
Sources: Financial Superintendence of Colombia and Banco de la República.

The Board of Directors agrees that, without new significant inflationary shocks, benchmark intervention rates will fall this year, at a speed that will depend on the new available information. Inflation has decreased, and will continue doing so towards the target range, and this will boost economic growth.

Considering all this, when assessing the evolution of inflation expectations, the increasing global uncertainty, and the behavior of domestic demand, the Board of Directors, at its meeting of December 2016, considered it appropriate to reduce the benchmark interest rate by 25 basis points and to keep it at 7.5% in January 2017, waiting for new information (Graph B).

Juan José Echavarría
Governor