Developments in Inflation and Monetary Policy Decisions

Global growth in the first quarter was slower than anticipated. Economic activity in the United States was weak and is expected to recover during the second half of the year. Growth in the euro area and Japan was modest, the Chinese economy continues to decline and growth in several Latin American countries is low or at negative rates. Therefore Colombia's major trading partners are likely to see less average growth in 2015 than in 2014.

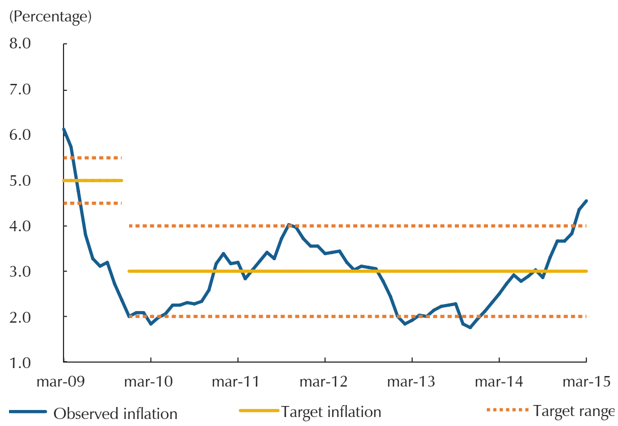
The strengthening of the dollar against most currencies has partially reversed and risk premiums for Colombia and other countries in the region have declined. This has eased upward pressure on the cost of the country's foreign financing. The oil market suggests that part of the accumulated decline in Colombia's terms of trade will be permanent and will have a negative impact on national income.

Given the international situation, the Colombian economy is adjusting to the new external conditions. Export revenues have declined, because of lower international prices for a number of export products, especially oil, and also due to the performance of industrial exports. As for domestic demand, consumption and investment have slowed in some sectors, consistent with the decline in national income and with fewer incentives to invest in the sectors producing natural resources. In view of this situation, the technical staff estimates economic growth during the first quarter of 2015 would be somewhere between 2.0% and 3.5%, with 2.7% as the most likely figure.

The forecast for the coming quarters is that the strength of the job market, the soundness of the financial system and the momentum in lending will help to temper the anticipated slowdown in consumption. Similarly, investments in civil works and construction should remain dynamic. Moreover, real devaluation of the peso is expected to have a positive impact on the performance of the export sectors and those that compete with imports. To the extent that the impact of the oil shock dissipates, it is natural to expect the economy to return to its long-term trend.

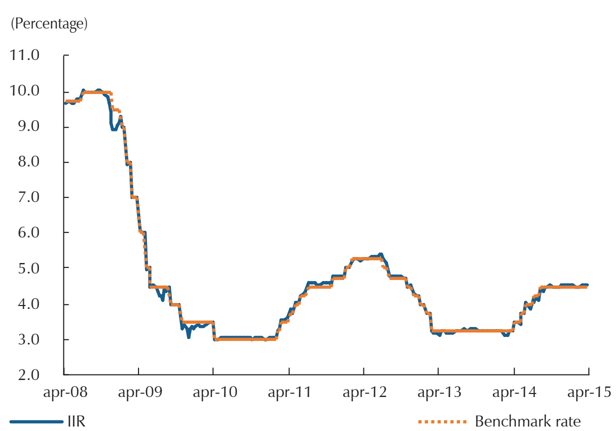
Taking all this information into account, *Banco de la República's* technical staff estimates economic growth in the second half of the year will be higher than in the first six months and will be somewhere between 2.0% and 4.0% in 2015 as a whole, with 3.2% as the central forecast. This forecast range is consistent with a projected current account deficit that would be less in dollars and, as a percentage of GDP, would be in a range of 4.2% to 6.1%, with 5.3% as the most likely figure. Approximately 0.9 percentage points of this estimate are explained by the reduced value of GDP in US dollars, given the higher level of the exchange rate.

Graph A
Total Consumer Inflation



Sources: DANE and *Banco de la República*.

Graph B
Banco de la República's Benchmark Interest Rate and the Interbank Interest Rate (IIR)
(2008-2015) [a/]



A/ The figures are data for business days; the last figure is for April 30, 2015.
Sources: Colombian Superintendence of Finance and *Banco de la República*

As for prices, inflation continued to rise during the first quarter of 2015 and was 4.56% in March (Graph A), which is above the target range set by the Board of Directors of *Banco de la República* for 2014. This deviation from the central forecast is explained largely by the temporary increase in food prices and, to a lesser extent, by the pass-through of peso depreciation to domestic prices. The average of the core inflation measures increased as well and was 3.65%.

In the second half of 2015, inflation should start to converge towards the long-term goal, to the extent that the food supply returns to normal. Although the pass-through of peso depreciation to prices for tradable goods is expected to continue for some months, few demand-side pressures and lower production and transportation costs caused by the drop in oil prices will help to offset these increases. Consequently, the forecasts suggest inflation will end up near the ceiling of the target range in 2015 and will continue to converge towards 3% in 2016.

In this economic environment, the Board of Directors of *Banco de la República* decided, at its meetings in February, March and April 2015, that it was appropriate to hold the benchmark interest rate at 4.5% (Chart B). An analysis of the current economic situation and prospects for the future suggests the rise in inflation is largely temporary.

In view of the fact that part of the reduction in national income would be permanent, domestic spending in the economy will have to adjust to reduce vulnerabilities and to create the conditions required for sustained growth in the future. The Board of Directors indicated it will continue to monitor the magnitude of that adjustment and its coherence with the long-term income level, with sustainability of the external deficit and, in general, with macro-economic stability. It further reiterated its commitment to keep inflation and inflation expectations anchored to the inflation target, while recognizing there has been a temporary increase in inflation.

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