Monetary Policy Report

A regular meeting of the Board of Directors of Banco of the República took place in the city of Bogotá D.C. on Friday, May 22, 2015. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit, José Darío Uribe Escobar, Governor of the Central Bank, and Board Members Carlos Gustavo Cano Sanz, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, César Vallejo Mejía, and Juan Pablo Zárate Perdomo.

These minutes contain a summary of the outlook of the technical staff of the Central Bank on the macroeconomic situation (section 1), followed by a review of the main discussion regarding monetary policy by the Board of Directors (section 2).

A more detailed description of the macroeconomic situation prepared by the technical staff from the Central Bank will be presented in the Inflation Report for the second quarter of 2015 and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. The new figures of global economic activity for the first quarter of 2015 ratified the weakness of external demand. In this period, the growth of the United States was low and below expectations, while the expansion of the euro zone was weak, although somewhat greater than had been forecast. China's GDP slowed down again, while the figures for economic activity of the major countries in the region suggest that their product will expand at low or negative rates. With this, it is likely that in 2015 the average economic growth of our trade partners be less than the one observed a year ago.

2. The increase in the benchmark interest rate of the US Federal Reserve is expected to begin towards the end of this year. In turn, the central banks in the euro zone and Japan continued their policy of strong monetary stimulus.

3. In the euro zone and to a lesser extent in the United States, the long-term interest rates on public debt bonds increased, but remain at levels lower than the average recorded in 2014. The US dollar, which had depreciated vis-à-vis most currencies in April and early May, changed this trend in the past week. Among the main countries of the region, the depreciation of the Colombian peso against the US dollar has been one of the most pronounced in the last week.

4. Oil prices have partially recovered, but still exhibit levels well below the average observed for the last five years. This behavior and that of other commodity prices exported and imported by Colombia indicate that in 2015 the terms of trade would register low levels, similar to those observed at the beginning of 2009. This fall in the terms of trade entails a significant loss in the dynamics of national income.

5. The behavior of external demand and of the prices of commodities has been reflected on the results of foreign trade in US dollars. In the first quarter of 2015, exports descended 30.2%, a fall explained mainly by mining (-41.8%), especially due to the lower price of oil. This period, external sales of the main agricultural products increased 24.5%, while those of the remaining sectors descended 11.6%. In the same period, total CIF imports accumulated a 4.4% fall.

6. As for the domestic context, the new information for the first quarter of 2015 and April indicates that economic activity in this period would have been less dynamic than the one registered in the last quarter of 2014. The information on retail trade, consumer confidence, and the survey of economic expectations by Banco de la República suggest a slowdown of consumption and private investment. On the supply side, the fall of industrial production, the lower growth of non-regulated energy demand, and the downturn in the present and future perception of trade indicate that economic growth will continue slowing down. Information on other activities such as oil, coffee and cement production suggests good behaviors.

7. As for the labor market, the figures to March 2015 show that the seasonally adjusted unemployment rate continues at historically low levels, with a dynamic occupation rate which is explained mainly by salaried employment.

8. In April, total corporate and household debt grew at a lower pace than the one registered in the first quarter, but greater than the nominal GDP increase estimated for the present year. This took place together with decreasing interest rates (for trade and consumption), which in real terms continue at levels below their historic averages (excepting credit cards).

9. With all this, the technical staff considers that growth during the first quarter would register between 2.0% and 3.5%, with 2.7% as the most probable outcome. For all of 2015, the most probable growth figure would be 3.2%, within a range of 2.0% to 4.0%. The amplitude of the interval reflects uncertainty over assumptions in possible extreme scenarios.

10. Regarding prices, inflation increased in April reaching 4.64%, a number higher than had been forecast by the market average and the technical staff at the Central Bank. Acceleration of inflation is explained mainly by the higher pace of increase in the prices of food, and secondly, by the increase in the prices of tradable and non-tradable goods excepting food and regulated goods. The average of core inflation completed seven months increasing, registering 3.84%.

11. Inflation expectations by market analysts and those derived from public debt bonds to 2, 3, and 5-year horizons are within a range of 3.1% and 3.5%.

In summary, the increase observed in inflation so far is due to transitory factors, and its medium-term expectations are close to 3.0%, within a context of slow-down in aggregate demand.

2. DISCUSSION AND POLICY OPTIONS

The Board Members agreed that the reduction in the terms of trade has a permanent component that affects national income negatively; therefore, the domestic demand should be adjusted. This adjustment process to the new external conditions is taking place in an orderly way.

Likewise, they agreed that product growth will slow down as part of this process. However, they differ in the magnitude of the slowdown and of the product gap resulting from this behavior. Yet, all output forecasts of the Board Members are within the forecast range of the technical staff of the Central Bank (between 2.0% and 4.0%).

The members of the Board coincide in that the slowdown of the aggregate expenditure will prevent inflationary pressures from taking place due to excess of demand, and that medium-term inflation expectations are anchored to levels consistent with the target. The anchoring of expectations and the absence of demand excesses are fundamental elements for inflation to converge to the target in the policy horizon. They also agree that if there were to be any phenomena that endangered achieving the inflation target in the policy horizon, the monetary authority will have to react in order to conjure said risk.

As for the level reached by the current account deficit of the balance of payments, the Board stated that this is one of the sources of greater vulnerability for the Colombian economy, and that, in that regard, the lower growth of internal demand and the real devaluation of the peso are necessary elements to reduce it gradually.

3. POLICY DECISION

The Board of Directors unanimously decided to maintain the benchmark interest rate at 4.5%.