[Monetary Policy Report]

A regular meeting of the Board of Directors of *Banco de la República* took place in the city of Bogotá D.C. on Friday, October 30, 2015. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; José Darío Uribe Escobar, Governor of the Central Bank; and co-directors Carlos Gustavo Cano Sanz, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, Cesar Vallejo Mejia, and Juan Pablo Zarate Perdomo.

The following is a summary of the vision of the technical staff at *Banco de la República* on the macroeconomic situation (section 1) and an overview of the main policy discussions considered by the Board of Directors (section 2).

Further detail on the macroeconomic situation prepared by the technical staff from the Central Bank will be presented in the Inflation Report for the third quarter of 2015 and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. Recent figures continue to reflect a weak dynamics of global economy, lower than expected in the *Inflation Report* issued in June 2015, and supported by domestic demand rather than by the foreign trade.

2. In the United States, the first GDP estimate for the third quarter exhibited a moderate growth, maintaining a favorable level. Household consumption consolidated as the main engine of this economy. According to projections by the members of the Federal Open Market Committee (FOMC), the first increase in the benchmark interest rate of the Federal Reserve would take place in December. On its part, the economy in the euro zone continues expanding at modest rates, also driven by domestic demand.

3. In China, several indicators suggest a deepening of the slowdown, despite the policy measures implemented. Exports and imports continue to contract in yearly terms. The slowdown in this economy would continue to have negative effects on the performance of global activity, on trade, and on international prices of commodities.

4. New data suggests that Colombia's main partners in Latin America will continue showing a very low dynamism, partly affected by the decline observed in the prices of raw materials. Particularly, it is expected that in 2016 Venezuela and Brazil register contractions in their product again, while countries such as Ecuador, Chile, Mexico and Peru would continue exhibiting lower growth rates.

5. With all the aforesaid, growth for Colombia's major trading partners in 2015 would be lower than had been forecast a quarter ago. For 2016, there would be a slight recovery, but slower than projected in the report.

6. In the third quarter, the price of oil was, on average, below the expectations of the technical staff. Factors such as the weakness of global demand, high inventories, and prospects of a high oil supply explained this behavior to a great extent. The prices of other commodities have also fallen. At the same time, the prices of goods imported by Colombia in US dollars have decreased beyond the forecast. This behavior of the prices of imported and exported goods has been reflected on a significant deterioration in the country’s terms of trade, which are at the lowest levels since early 2009. However, deterioration has been lower than estimated by the projections in the *Inflation Report* issued in June.

7. This behavior of the prices of exports and the deterioration of the quantities exported (except for the main agricultural goods) were reflected on a decline in the value of exports in US dollars. In July-August, external sales fell 41.1% on a yearly basis, a decline explained mainly by the behavior of mining and by other exports different from major agricultural items. So far this year to August, total exports have fallen 33.8% on a yearly basis.

8. In spite of the depreciation of the peso, the decline in the prices of imported goods in US dollars and a domestic demand which was not as weak as projected, would have explained in part a slower-than-estimated adjustment of imports in US dollars. In July-August, total imports fell 14.4% on a yearly basis, and so far this year to August they accumulate an 11.8% decline.

9. With the above, it is likely that in the third quarter deficits in the trade balance and current account related to GDP would have accelerated. For all of 2015, an external deficit between 5.7% and 6.8% of GDP is expected, with 6.2% as the most likely figure.

10. In Colombia, the most recent figures for the third quarter suggest that growth could have been better than expected. On the side of demand, retail sales (excluding vehicles) and the behavior of the consumption portfolio would indicate that household spending continues to be dynamic, despite the low levels in confidence indexes. Investment expectations show that investment different from civil works would maintain a yearly deterioration similar to the one recorded in the second quarter, while construction and civil works would continue to be dynamic. On the supply side, indicators for industry, trade and construction (cement production and licenses), among others, have performed better than expected.

11. The unemployment rate continues at low levels, although the employment generation has deteriorated in recent months, particularly,

that of formal salaried employment.

12. Real interest rates for credits continue below their historical averages, and the evolution of the portfolio reflects a dynamic domestic demand.

13. Considering the aforesaid, the Central Bank revised upward its most likely growth forecast for 2015 to 3.0%, within a range between 2.4% and 3.4% (the previous range was between 1.8% and 3.4%, with 2.8% as the most likely figure). For 2016 a similar growth rate is expected (3.0%), within a range between 1.5% and 4.0%.

14. In September, annual consumer inflation stood at 5.35% on a yearly basis, surpassing market projections and those of the technical staff. All the main groups accelerated. The group of regulated items was the only one that posted within the inflation target range. Core inflation indicators increased again and are above the ceiling of the target range; their average (4.89%) is the highest since April 2009.

15. All measures for inflation expectations increased in the last month and are higher than the long-term goal (3.0%). Particularly, those derived from public debt bonds are above the ceiling of the target range.

In all, the sharp increases in the prices of goods that are mostly affected by the depreciation of the peso and by adverse weather conditions have continued pressing inflation upwards. Prices of other goods and services also show increasing variations, which may reflect indexation, expectations of higher inflation in the future, or pressures in costs in these sectors. The behavior of these prices does not seem to indicate the existence of a significant deterioration of aggregate demand. Thus, the risk of a slowdown in domestic demand beyond consistency with the decline in national income has moderated, in a context of increasing inflation expectations.

2. DISCUSSION AND POLICY OPTIONS

The majority of the Board Members agree that the increases in inflation reflect not only the impact of transitory shocks attributable to*El Niño* and devaluation, but also the effect of higher inflation expectations and the existence of past excess expenditure which exerts pressures on the current account deficit of the balance of payments. The announcement of stronger and enduring conditions due to *El Niño* than initially forecast and uncertainty about the future behavior of devaluation and its pass-through to prices have increased the risk of medium-term inflation expectations becoming unanchored form the target. They believe that an increase in the benchmark interest rate is necessary not only to anchor expectations, but to prevent inflation pressures or external vulnerability generated by excess demand.

As for the magnitude of the increase in the benchmark interest rate, there were several opinions. The majority of members opined that the increase should be of 50 bp. In their opinion, the new data available of domestic demand and inflation expectations calls for a stronger reaction than the one taken in the previous meeting of the Board.

Other co-directors, although sharing the macroeconomic diagnostics of the majority, consider that the appropriate policy decision is to increase the benchmark interest rate by 25 bp. In their view, this strategy would be suitable to deal with the current inflationary situation for the following reasons: (i) it is very likely that a path of increases in the benchmark interest rate be required. Considering this, a gradual and (if necessary) persistent adjustment of the reference rate would be preferable; (ii) this adjustment would allow to better calibrate increases in the benchmark rate according to the new information available, which is very useful within a scenario of high external uncertainty, as is the current case; and (iii) such a strategy facilitates communication with the market, allows for greater predictability of future rates, and improves the pass-through of monetary policy.

One of the Board Members emphasized the transitory nature of the acceleration of inflation due to *El Niño* and to the variation of the exchange rate. Although there are no demand pressures, this member considers that if the objective is to control inflation expectations, a 25 bp increase accomplishes this purpose.

3. POLICY DECISION

The Board of Directors of Banco de la República, by majority, decided to increase the benchmark interest rate by 50 bp to 5.25%.