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, February 19, 2016. 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 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).

Further detail on the macroeconomic situation prepared by the technical staff from Banco de la República will be presented in the Monetary Policy Report of January 2016 and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. During February, turmoil in international financial markets continued. According to analysts, this can be explained by factors such as concerns about financial stability, the prices of commodities, and global growth (particularly in China and other emerging countries).

2. The rates of the long-term sovereign bonds of the United States fell significantly, suggesting that the markets expect normalization of the monetary policy in the US to be slower than projected by the FOMC last December.

3. In Latin America, currencies depreciated and the countries’ risk premia increased, reaching the highest levels since 2009.

4. The US dollar, on the other hand, reversed part of its appreciation vis-à-vis the main currencies.

5. The price of oil remained at its lowest levels since 2003. The announcement issued by some of the main oil producers about not increasing their production would not impact the market, as there would still be an oversupply of oil. The international prices of gold and silver rose significantly, while those of copper, coal, nickel and food remained low. With this, Colombia’s terms of trade would have remained at their lowest since 2003.

6. In January, inflation would have continued low in the United States, the euro zone and China, while in Latin America it would maintain its upward trend and out of the monetary authorities’ target range in Brazil, Chile, Peru, and Colombia.

7. Regarding real activity, GDP in the fourth quarter of 2015 shows that the United States has slowed down and the euro zone continued recovering slowly. In the region, Peru exhibited an important acceleration according to activity indicators. The scarce information available for January suggests that these trends would continue.

8. During 2015, the value of exports in US dollars fell 35.1%, particularly due to the behavior of the prices of mining goods. Preliminary information from DIAN for January shows that they are still contracting. On the other hand, according to the preliminary report on foreign trade by DIAN, regarding imports, in December 2015 the total recorded an annual 25.4% fall, while in January of 2016 it would have contracted 34.3% annually.

9. On February 16, Standard & Poor's (S&P) revised the prospects of Colombia's long-term sovereign debt from stable to negative. This decision was reached considering the decline in the forecasts for oil prices, which generates risks of a further deterioration in the foreign position of the country as well as in public finances and growth, particularly if the government does not take the fiscal measures required on time.

10. In Colombia, the information available for the fourth quarter of 2015 suggests that the economy would have grown at a rate similar to that of the third quarter. Industry showed a favorable expansion, while trade slowed down. In 2015, the unemployment rate stopped falling and would have begun to rise slightly, according to the trend component of the seasonally adjusted series.

11. In January, consumer confidence plummeted, reaching the lowest since April 2002. The component for current economic conditions, as well as that for expectations, fell. Also, the future perception of the labor market deteriorated.

12. On the supply side, oil production fell below one million barrels per day, and coffee production slowed down due to the effect of a high base of comparison in 2015.

13. In the same month, the real interest rates on commercial and consumer credits began to increase, although they remain at low levels compared to their historical averages.

14. Given that the information is very scarce, the forecast range for GDP growth for 2016, which shows a downward bias, is maintained. Growth would post between 1.5% and 3.2%, with 2.7% as the most likely figure.

15. Regarding yearly inflation, it accelerated in January reaching 7.45%, particularly due to the sharp increase in food prices (12.26%). Within this group, perishable goods increased 31.3%. Non-food inflation also accelerated (from 5.17% to 5.54%). The average of core inflation indicators monitored by the Central Bank stood at 5.73% on a yearly basis.

16. The annual CPI variation in January is the highest since December 2008.

17. According to the monthly survey applied to financial analysts in February, a yearly inflation rate of 5.49% is expected for December 2016, a figure higher than expected in the January survey. To twelve and twenty-four months, analysts expect 4.54% and 3.70%, respectively, figures similar to those from the previous survey (4.50% and 3.68%). Inflation expectations embedded in public debt bonds with information to February 16 registered above 4.5% for 2, 3, 5, and 10 years, at levels similar to those of January.

18. The effects of El Niño, pass-through of the depreciation of the peso to prices, and the activation of indexation mechanisms on prices and salaries could keep inflation high during the first semester of the year. Shocks in food prices and depreciation are expected to begin fading in the second semester, which, together with actions in monetary policy should lead inflation towards its target during 2017.

In summary, higher-than-expected increases in food prices and further increases in the exchange rate, largely related to the fall in the price of oil, continue exerting upside inflationary pressures. Inflation expectations remain high and an additional pass-through of the devaluation of the peso to domestic prices is foreseeable. Uncertainty about the persistence of the low level of the Consumer Confidence Index and its impact on household spending is high. Other indicators of economic activity are compatible with the technical staff's growth forecast for 2016 (2.7% as the most likely figure, within a range between 1.5% and 3.2%).

2. DISCUSSION AND POLICY OPTIONS

The members of the Board agreed on the need to continue increasing the benchmark interest rate in order to ensure convergence of inflation expectations to the goal and an increase of domestic demand consistent with a lower growth of national income. They also highlighted that the adjustment of the current account deficit should be a priority of macroeconomic policy. Accordingly, they agree in that the monetary and fiscal policies should act in order to reduce the increase in public and private spending, thus creating the conditions for the economy to achieve convergence of inflation to the target and external sustainability.

The majority of the Board Members considered that it is appropriate to continue with the path of 25 bp increases. Some of them pointed out that recent data on consumer confidence show that economic variables may experience strong changes shortly, which stresses the suitability of a gradual adjustment process to incorporate the new information. Once more, the evidence of stronger pass-through mechanisms of the monetary policy that might impact the future evolution of the benchmark interest rate was noted. Others emphasized that in recent weeks, the price of oil has reached a more stable level, which could indicate that in the coming months the devaluation of the peso would not continue at the pace observed recently, which would in turn contribute to the stabilization of inflation. Finally, some stressed that the pace of adjustment of the benchmark interest rate could increase should there be inflationary surprises.

The other members of the Board proposed a 50 bp increase in the benchmark interest rate. They are especially concerned with inflation expectations being de-anchored from the target and the strong increase of inflation in a context of uncertainty over the degree of indexation of decisions regarding prices and wages. They also consider that there is high uncertainty about the true elasticity of inflation to the output gap as well as over the adequacy of the adjustment expected in domestic demand to reduce inflationary pressures and the external imbalance. In this context, a 50 bp increase in the reference rate leads to a low risk of excessive adjustment in the growth of expenditure and output. Finally, they believe that, should the dynamism observed in domestic demand continue, sustainability of growth could be compromised due to the high level of deficit in the current account and the weak response of exports to the real devaluation of the peso. Hence the importance of the adjustment of public spending announced by the national government, of the timely submission and approval of a structural fiscal reform, and a faster reaction of the monetary authority to the behavior of inflation and inflation expectations.

3. POLICY DECISION

The Board of Directors of Banco de la República, by majority, decided to increase the benchmark interest rate by 25 bp to 6.25%.

Bogotá, D. C.

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