Monetary Policy Report
Contenidos relacionados
Banco de la República increases the benchmark interest rate by 25 basis points

A regular meeting of the Board of Directors of Banco de la República took place in the city of Bogotá D.C. on Friday, July 29, 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 by 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 June and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. To date, the electoral outcome that would imply withdrawal of the United Kingdom from the European Union (brexit), has had a limited impact. While the US dollar has strengthened vis-à-vis the main currencies of the world, indicators of financial volatility, risk premia, and exchange rates of emerging countries returned to pre-brexit levels.
2. However, it cannot be ruled out that the brexit may have significant impacts on global economy. Uncertainty over the adjustments that the United Kingdom and the countries of the EU would need to assume may affect the confidence of consumers and enterprises, thus interrupting the slow recovery of the European economy, which would impact global growth negatively.
3. In the United States, the Federal Reserve is expected to continue with the gradual normalization of the monetary policy. In this context, it is foreseen that the monetary policy in developed economies will remain highly expansive. This could encourage a greater flow of capital to emerging countries, as has been observed in recent weeks.
4. Growth forecasts for the country's main trading partners for the whole year and for 2017 incorporated into this report, include a slightly lower growth rate for the euro zone and the United States than had been foreseen in the previous quarterly report. China would continue with a mild slowdown, as has been observed. Negative growth is still expected for the region, with a slight rebound in 2017.
5. In recent weeks, the price of oil has shown stability, while international prices of other goods exported by Colombia have increased and several foodstuffs imported by the country have decreased. With this, the terms of trade continued to recover and are expected to be higher for the entire year than had been forecast in the previous quarterly report, although lower than in 2015.
6. Foreign trade figures from DANE for the two-month period of April-May show a sharp fall in the value of exports (-22.3%), although lower than the one recorded in the first quarter. Imports fell 18.1% in the same period. This suggests that the correction of the deficit in the trade balance observed in the first quarter would have continued during the second.
7. Regarding the country's current account, the trend of adjustment of the current external imbalance observed in the first quarter is expected to continue for the remainder of the year. For 2016, a current account deficit of around 5.3% is foreseen, lower than the one registered in 2015.
8. In Colombia, the data available on economic activity for the second quarter suggest that the economy would have grown at a pace similar to that of the first quarter. The fall in investment would have been lower, offsetting the moderation of private consumption and the low growth rates for public consumption. On the supply side, the indicators available for the second quarter of 2016 show that the industry and trade recorded favorable dynamics, while mining, agriculture, and energy had a less-dynamic performance.
9. The seasonally adjusted labor market series show that, to May, the unemployment rate remains low, given that the labor supply (measured as the global participation rate) has fallen, which has offset the deterioration in employment creation. Job creation continues to be driven by salaried employment, which suggests that the quality has not deteriorated.
10. Transmission of the increases in the benchmark interest rate to credit rates continues in a context in which credit has slowed down somewhat.
11. With all this, economic growth between 2.0% and 3.2% is expected for the second quarter. For 2016, the most likely growth figure was revised downwards, from 2.5% to 2.3%, with a forecast range between 1.5% and 3.0%. In this projection, both consumption (public and private) as well as investment continue slowing down, partly as a response to the slower dynamics of national income.
12. For 2017, growth of the economy is estimated within a range between 1.5% and 3.5%.
13. In June, yearly consumer inflation increased, reaching 8.60%. This increase is explained by the variation in the prices of food (14.28%), regulated items (6.71%) and, to a lesser extent, non-tradable inflation (excluding food and regulated items) (4.97%). The average of core inflation indicators increased 20 bp, standing at 6.52%.
14. Inflation expectations obtained from the monthly survey of economic analysts increased to one year (from 4.37% to 4.61%), but remained stable for a two-year period (moving from 3.67% to 3.68%). Those obtained from the quarterly survey of economic expectations to 1 and 2 years increased, exceeding 5.0%. Regarding the average for June, so far this month, the expectations embedded in public debt bonds (Breakeven Inflation) were relatively stable for all terms (2, 3, and 5 years), posting between 4.0%

and 4.4%.

15. Shocks in food prices and depreciation are expected to begin fading in the second semester, which, together with monetary policy decisions, should lead inflation towards its target range during 2017.

In all, inflation rose due to the past depreciation of the peso, the lagged effects of El Niño (which is already over), inflation expectations exceeding the target, and by the activation of some indexation mechanisms. Similarly, the Colombian economy continues to adjust in an orderly manner to the strong shocks recorded since 2014, and the current account deficit is correcting gradually.

2. DISCUSSION AND POLICY OPTIONS

The members of the Board emphasized that the recent data on inflation exceeded the expectations of the market and the Central Bank's technical staff. The causes and consequences of this phenomenon were discussed by the members of the Board to determine their position regarding the monetary policy stance.

The majority of Co-directors voted in favor of increasing the benchmark interest rate by 25 bp. This group highlighted that the results of inflation continue increasing beyond the forecast, with accelerations in the yearly variation of the prices of several components of the CPI, and monthly adjustments in the prices of an atypically high proportion of the items comprised by this index. They noted that persistence of inflation at levels above the target reinforces deanchoring of inflation expectations and activates indexation mechanisms. This reduces the credibility of the monetary authority and decreases the probability of reaching the target of 3.0% (+/- 1 pp) in 2017. An additional increase in the benchmark interest rate decreases the likelihood of a scenario in which inflation persists at a level incompatible with the target established by the Board of Directors of Banco de la República.

Within the majoritarian group, the co-directors emphasized several ideas. Some noted that insufficient efforts to control high or increasing inflation at the moment would very probably result in loss of credibility, and, therefore, in an eventual disinflation, more costly in terms of output and employment. They also stated that, facing the strong uncertainty of international markets, the risk of future pressures towards depreciation persist, and through this channel, also on inflation. Additionally, they noted that, given the orderly adjustment of the Colombian economy, there is still room for a further increase in the benchmark interest rate without generating an excessive deceleration. Finally, another member of the group stated that there is a great deal of uncertainty about the level at which expectations are being anchored. As a result, there are likely scenarios in which the anchoring point may be greater than the one implicit in the prices of public debt. Also, that there are probable scenarios of an over-adjustment of the monetary policy. With the recent information, this member stressed that on this occasion there is a greater risk of de-anchoring inflation expectations, for which reason s/he supported the increase in the benchmark interest rate.

Another group of co-directors voted in favor of maintaining the benchmark interest rate at 7.5%. This decision was justified on the following reasons: (i) domestic demand shows evident signs of deceleration; ii) the expected evolution of global economy, particularly that of Colombia’s trading partners, suggests a further deterioration of foreign demand; (iii) domestic demand will receive another negative shock in the policy horizon, either from the contraction in spending implied by the draft of the budget for 2017, or from the tax reform announced by the Government; (iv) the recent increase in inflation is due to new supply shocks, which have not affected medium term expectations; and (v) the current level of the interest rates is high, which induces convergence of inflation to the target in the policy horizon.

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 7.75%.