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This is the second edition of a publication by the Governor of the Central Bank of Colombia, addressed to citizens, analysts, and domestic and foreign investors interested in learning about the most recent events in the Colombian economy and their implications for monetary policy decision-making. It is published quarterly in Spanish and in English, and the Statistical Annex is updated on a monthly basis.

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## EXECUTIVE SUMMARY

The fall in the price of oil since the middle of 2014 generated significant macroeconomic imbalances and reduced the long-term growth of the Colombian economy. The scope and duration of these effects can be explained by the multiple links of the oil activity with the other economic sectors of the country, and by the nature of the shock, i.e., not anticipated, of considerable magnitude, and persistent in time. The oil shock resulted in a sharp deterioration in the terms of trade that contracted the country's external revenues and those of neighboring economies, and generated a widening of the current account deficit. Similarly, it reduced government resources, inducing an increase in the fiscal deficit. With these imbalances, the shock shifted economic production to a lower level, given its negative impact on aggregate demand and on the production system. This, together with the lower accumulation of capital that took place since mid-2015, affected the potential growth of the economy, which is estimated to have fallen from 4.5% on a yearly basis to a current range between 3.0% and 3.5%.

A growth rate lower than 4.5% is insufficient to meet the great needs of the Colombian economy. A successful adjustment will allow the country to correct the macroeconomic imbalances generated by external shocks, as well as to eradicate all vulnerabilities that may affect our ability to deal with new unfavorable episodes in the external and internal fronts. This is the only way to create the conditions for greater growth, and to increase our growth potential once more.

The process of adjustment and correction to vulnerabilities has been progressively taking place over the three years following the oil shock, and the most recent information suggests that it is currently in its final stage. The macroeconomic imbalances induced by the shock have been mostly corrected; risk premia have decreased, and there are favorable conditions for the economy to reach a turning point, with higher growth during the second half of 2017, and even more during 2018.

Other events subsequent to the fall in the price of oil imposed additional challenges to the adjustment process, particularly to monetary policy. The strong depreciation of the Colombian peso between August 2014 and August 2016 (close to 90%) contributed to the external adjustment by inducing a shift in spending towards domestic goods and providing a stimulus to the generation of non-oil external revenue, as detailed below. However, the depreciation also produced a significant upward pressure on the level of consumer prices as a result of the increases in the domestic prices of final goods and imported inputs. Additionally, there were other transitory shocks such as *El Niño*, the trucking strike, and more recently the VAT increase, which also generated significant inflationary pressures on food and other basic household goods. Although the direct effects of these shocks on inflation have already vanished for the most part, indirect effects associated with the indexation of prices and wages and with variations in expectations still remain, as evidenced in the annual inflation figure for non-tradable goods at the end of August (5.23%), and in the average of core inflation indicators (4.74%). These pressures will disappear as inflation expectations continue to converge toward the 3.0% target.

Between August 2015 and July 2016, the monetary policy rate increased from 4.5% to 7.75%, and the variations were transmitted to the financial system´s interest rates for both deposits and loans, and with greater intensity to the interest rates on commercial loans. The monetary policy and the aforementioned dissolution of the transitory supply shocks created the conditions that led to the reduction in the annual inflation rate from a peak of 8.97% in July 2016 to 3.87% at the end of last August.

The decline in headline inflation, the reduction of the current account deficit, and the weakening of domestic demand led the Board of Directors of the Central Bank to begin a cycle of reductions to the policy rate since December 2016, without compromising the convergence of inflation to the target, nor the macroeconomic adjustment in course. Between December and August, the Board reduced the rate 250 basis points to a level of 5.25% last month. The commercial interest rates reacted with falls even larger than those of the policy rate, except those for the building sector. In contrast, household credit rates have exhibited a limited response, particularly those for credit cards and consumer loans. Monetary policy shifted from a strongly contractionary position in early 2017 towards a neutral position at present. An expansionary policy could follow ahead, but inflation is still far from the 3.0% target, and the adjustment of the current account has not been completed yet.

The Colombian economy should not complete this process of adjustment with a greater level of debt because it would affect its capacity to deal with future external shocks, which are likely to happen in a highly uncertain international environment. For the adjustment of the economy to be successful, it is also necessary to continue with the fiscal adjustment in order to ensure the reduction of public debt, as envisaged in the current fiscal rule.

Given the uncertainty about the international financial conditions, it is also important to avoid falling back into an excessive level of external indebtedness. For this reason, in order to achieve a sustainable recovery, the economy needs to strengthen external income and find products and alternative markets for exports to replace the lower income from oil and mining exports. Should this improvement not be achieved, the vulnerability of the economy would increase, and the recovery of economic activity may not be sustainable in the mid-term. Fortunately, as suggested in the remainder of this report, recent figures show that between January and July of this year a rebound in the different revenues related to the external sector began to take place, and this will reduce our current account deficit.

Indeed, during the last seven months total exports grew at an annual 22.7% rate, with increases in external sales of mining products (34.8%), agriculture (12.9%), and other exports (7.8%), after having remained negative for more than three years. The increase in the value exported was due to an improvement in external prices (particularly for minerals), but it also reflects an increase in quantities, mainly in services and agricultural products. Should this trend continue and deepen, the Colombian economy could ensure a sustainable recovery, without incurring the risk of widening external imbalances and levels of indebtedness.

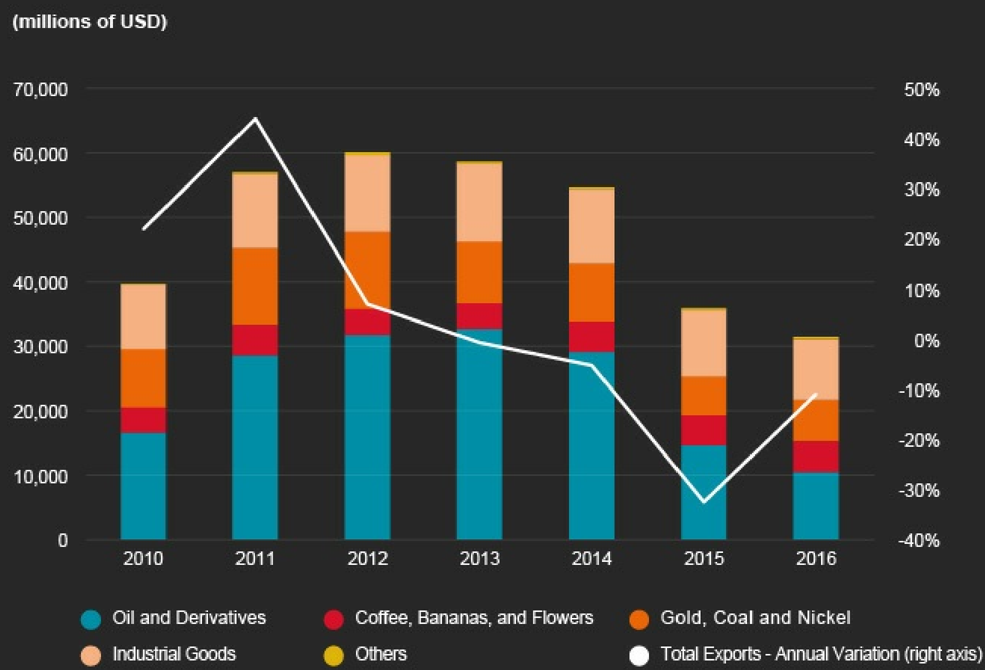
The country's current revenues are composed mostly by exports of goods, followed by external sales of services, current transfers (particularly workers' remittances), and revenues from foreign investment. This report examines the recent behavior of each of these components.

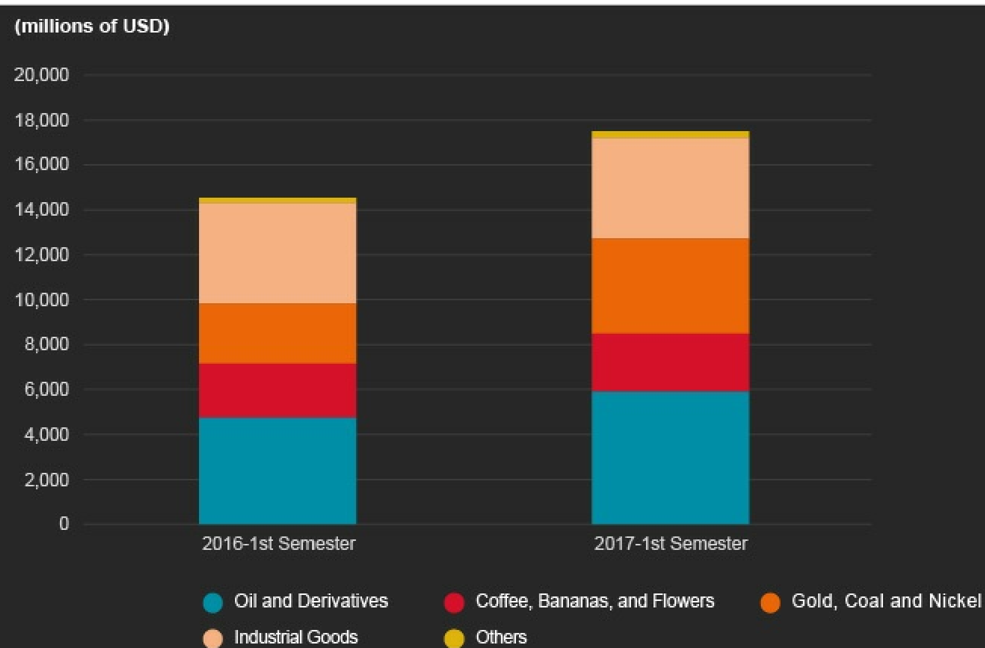
## 1. Exports of Goods

Exports of Goods | Exports of Services | Annex

Total exports of goods decreased 47% (USD -27,429 million) between 2013 and 2016, from USD $58,824 to USD $31,394 million (Graph 1), mainly due to the fall in international prices of oil and of other mineral products. Indeed, lower external sales of oil and its derivatives explained close to 80% of the decline in total exports in this period. The decline in sales of coal, gold, and ferronickel, as well as in some industrial products, also stands out.

*Graph 1*
**Total Exports classified by Type of Product**

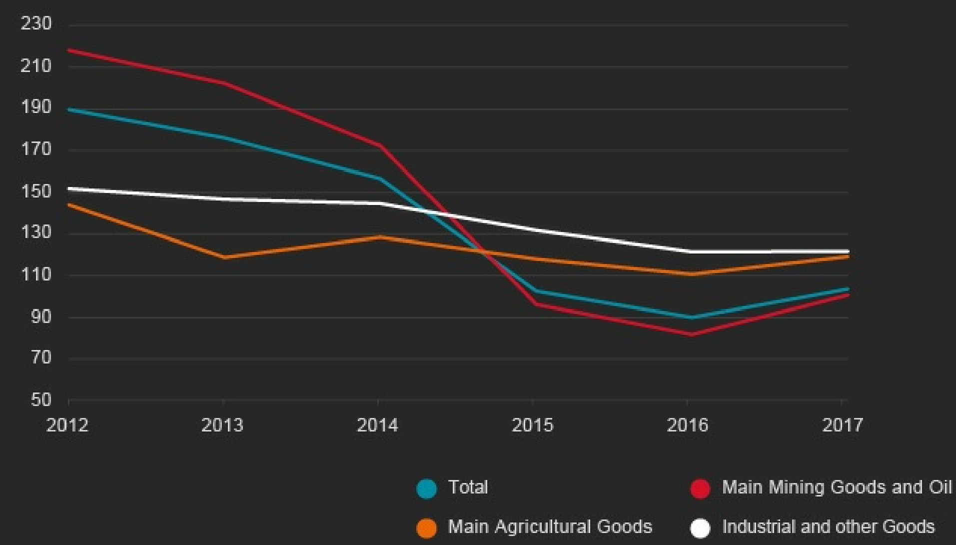



Source: DANE, *Banco de la República*.

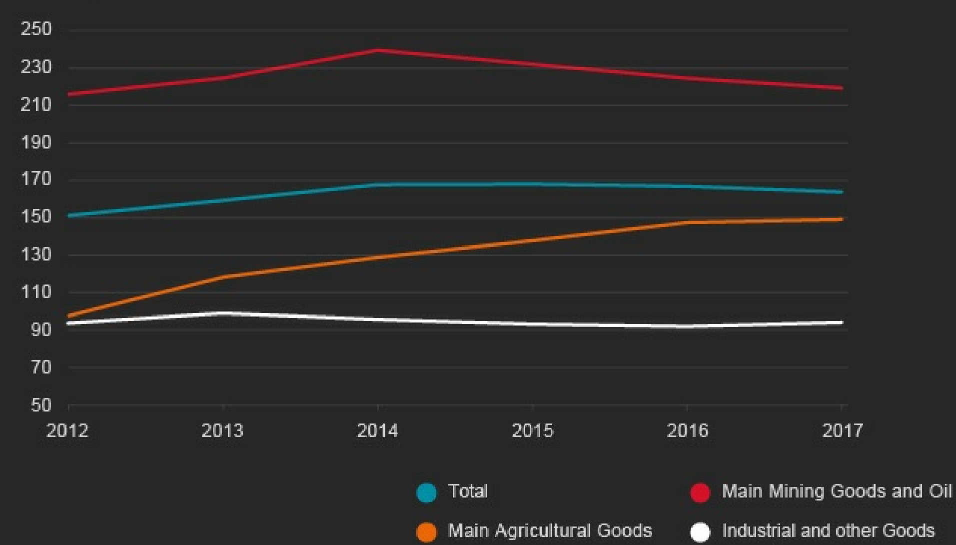
The reduction in the international price of oil was caused by a combination of factors, including an increase in oil supply associated with the exploitation of non-conventional crudes (particularly in the United States), the low demand of hydrocarbons due to the stagnation of the global economy, and the increased use of alternative energy sources, among others. The decline in exports of mining goods in Colombia caused a fall of their participation in the total value exported, which became visible starting in 2013 and which was heightened since mid-2014 due to the collapse of the international price of oil and other minerals (Graph 2). This situation reduced investment in the sector, which in turn was reflected in smaller quantities produced and exported (Graph 3). The country's exports registered a change in their composition in favor of agricultural and industrial goods, which also exhibited a poor performance.

*Graph 2*
**Index of Export Prices**




Source: DANE, *Banco de la República*.

*Graph 3*
**Index of Export Quantities**




Source: DANE, *Banco de la República*.

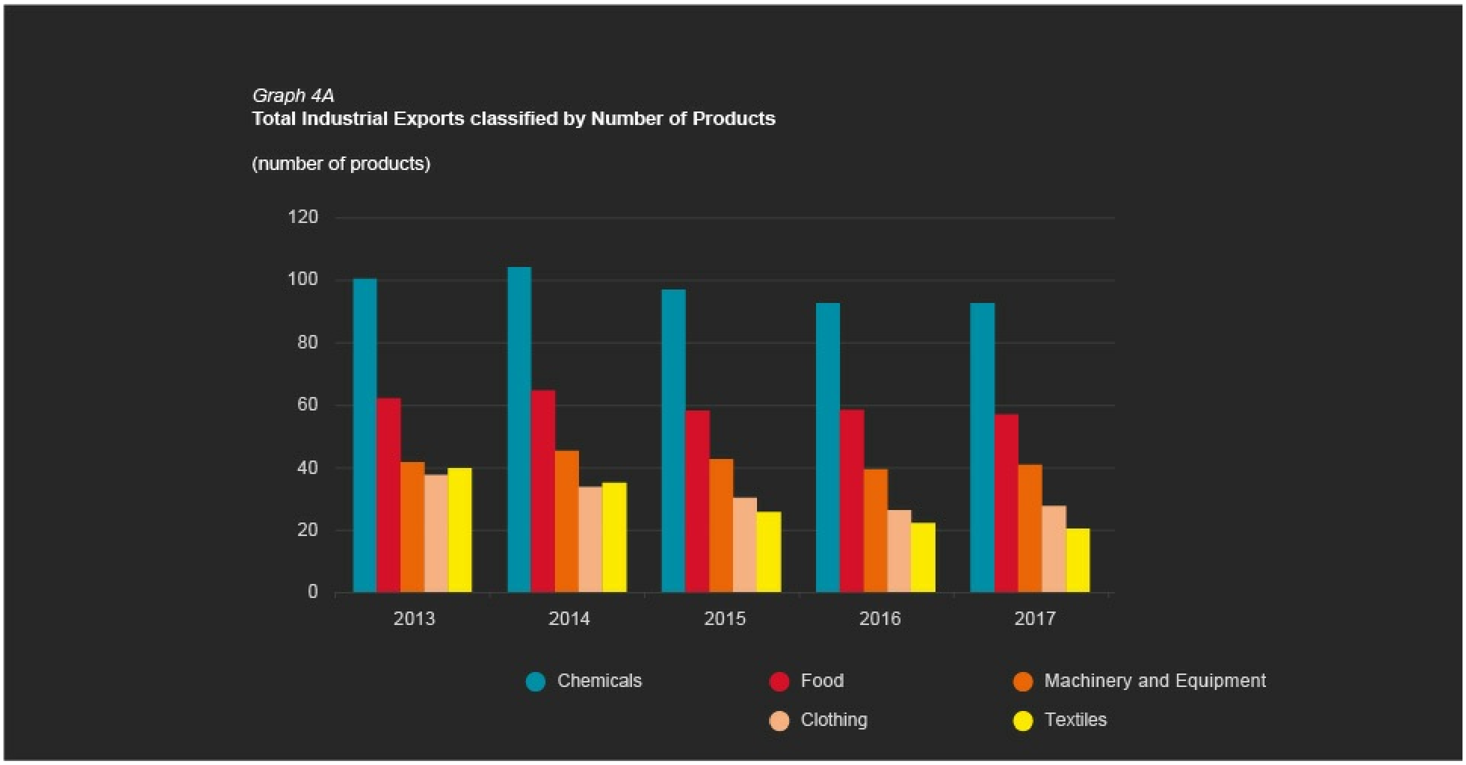
Natural resources, gold, and ferronickel play a central role in Colombian exports; therefore, it is still essential to take advantage of the country's mining potential, and to exploit strategic resources that can be inserted in the global value chains of goods with high technological content. In the first half of 2017, external sales of oil and its derivatives increased at an annual rate of 24.2% (Graph 1), due to the recovery of their international prices (Graph 2), as a response to a rebalancing of the global oil market that managed to offset the reduction in the quantities released. Additionally, the export value of coal increased 55% due to better international prices and greater quantities sold. As a result, during the first half of 2017, total exports exhibited a significant recovery, increasing at an annual rate of 20% (USD $2,963 m).

Between 2013 and 2016, exports of the main agricultural products performed well in prices and volumes (Graph 3), with outstanding results for banana and coffee, which grew 20% and 28%, respectively. It is worth noting that the Colombian banana entered five new markets in Asia in 2016, and is currently exported to 15 European countries. Coffee dispatches maintained their positive trend, increasing 13% in 2017. Something similar happened with flowers (8.0% growth).

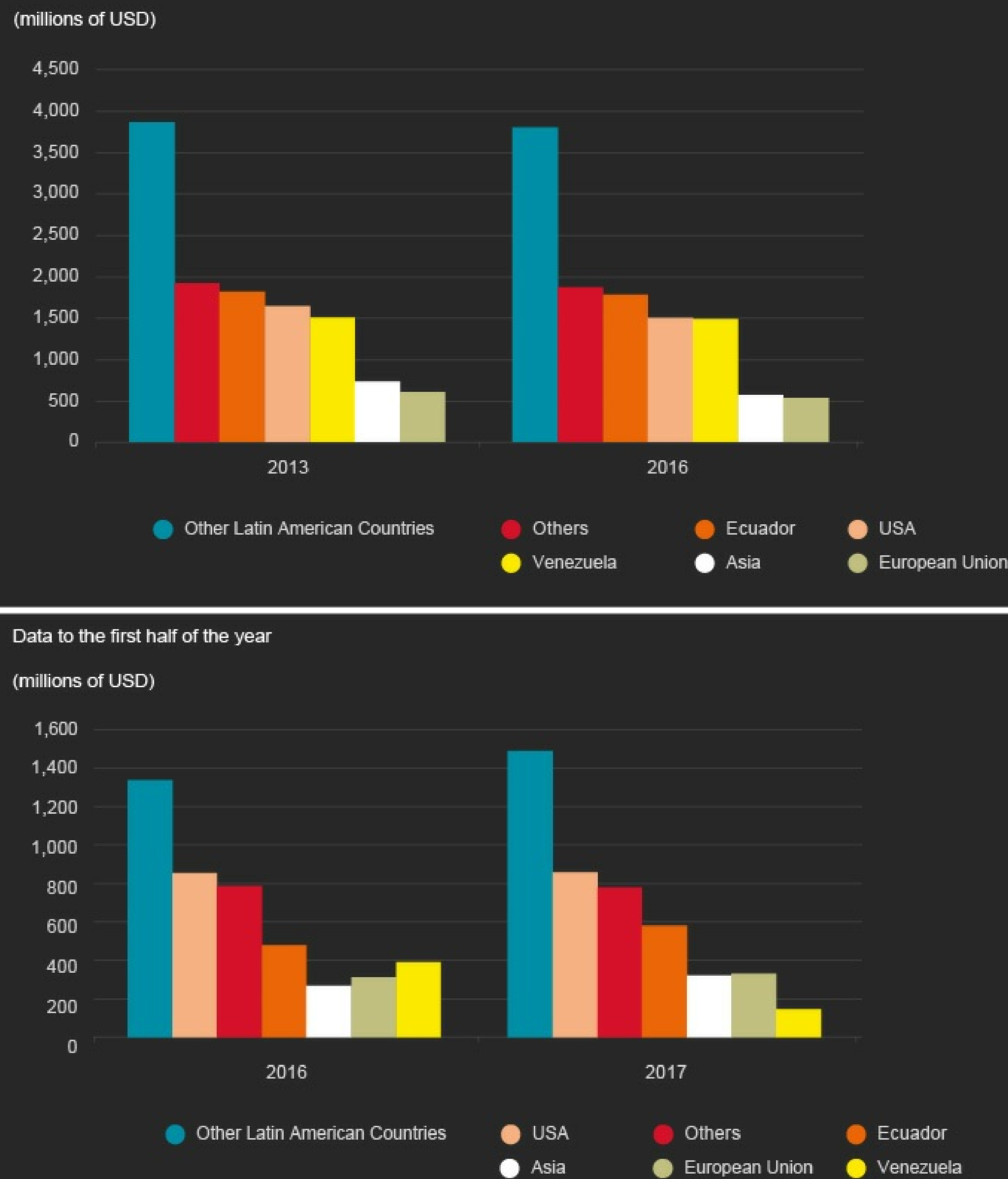
External sales of other agricultural products have maintained a mixed performance after the oil shock. From the second half of 2015 and up to the first half of 2016, they had positive annual growth rates, higher than 10%. However, since the end of 2016 and so far in 2017, their value has fallen. Nevertheless, the number of destinations has increased, particularly towards Caribbean countries.

Exports of industrial goods fell by about 22% during 2013-2016, and for the first six months of 2017 their growth continued to be low. The decline in exports of manufactures has been explained mainly by the reduction of sale prices in US dollars (Graph 2), and—to a lesser extent—by the fall in the quantities sold (Graph 3). Similarly, the number of exported products fell in all sectors (Graph 4A), particularly in manufactured exports to Latin America (Graph 4B).

The downward trend in exports of industrial goods stopped since mid-2016, and some sectors began to show signs of recovery (Graph 1). For example, rubber and plastic exports registered an average 2.1% annual growth since August 2016, mainly explained by the behavior of the quantities exported. Exports of food and beverages have also been regaining their level from before the oil shock, and are reacting positively since the first months of 2017, with an average annual 2.3% growth (mainly explained by the behavior of quantities). Chemical products, the main component of our manufactured exports, also show a recent increase in value and in the number of products exported (Graph 4).



*Graph 4B*
**Industrial Exports classified by Destinations**

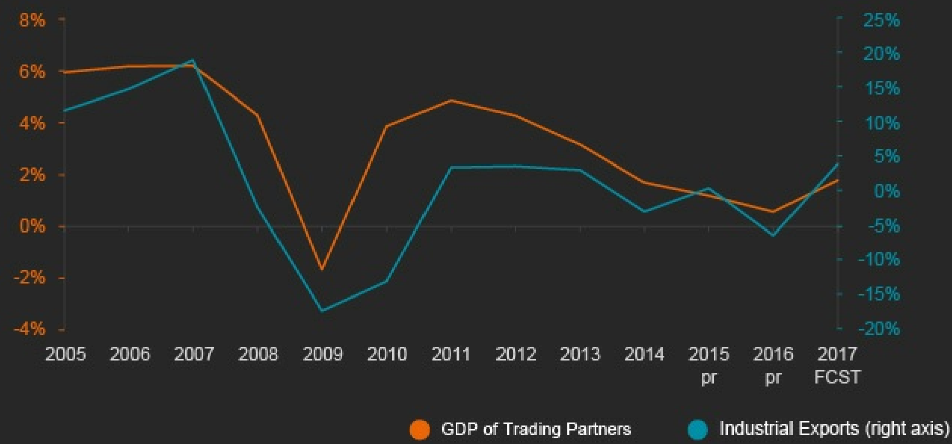



Note: : Graph 4A considers only exports that exceeded USD $10,000 per month and six-digit tariff headings.
Source: DANE, *Banco de la República*.

Several factors are associated with the poor export performance of manufactured goods in recent years. On the one hand, the weakening of external demand, measured as the economic growth of the country's trading partners. After the crisis in 2009, the average GDP of Colombia’s partners increased by nearly 5.0% in 2011, and later began to show a decreasing trend, which continued until 2016, when it reached 0.5%. This behavior was explained both by the low growth of developed countries (mainly the United States and European countries), as well as by the economic slowdown of our Latin American partners, particularly Venezuela (Graph 5), several of which are buyers of Colombian manufacturing exports. As long as external demand recovers, industrial exports should record a higher growth in 2017 and 2018.

*Graph 5*
**Average GDP for Trading Partners and Real Industrial Exports**

(Annual Variation %)




(pr): preliminary; (FCST): forecast.
Note: Partners' growth, weighted by industrial exports. Real industrial exports are estimated based on the estimated external inflation in US dollars.
Source: IMF, *Banco de la República*.

Another factor that prevents a better performance of industrial exports is the high cost of doing business in Colombia. Non-tariff barriers have increased gradually over the past two decades, and tariffs (mainly on agriculture) are excessively high, increasing the cost of imported inputs and capital goods, and causing domestic production and the export supply to become more expensive. Between 1999 and 2012, the cost of transporting goods to Colombia once they are embarked in a foreign port ranged between 35% and 52% of their FOB value, reaching 36% in 2012. Close to 70% of this total cost originated in non-tariff barriers (internal transport, port operation, and prior procedures, among others), and the remaining amount is caused by international transportation costs and high tariffs in Colombia.

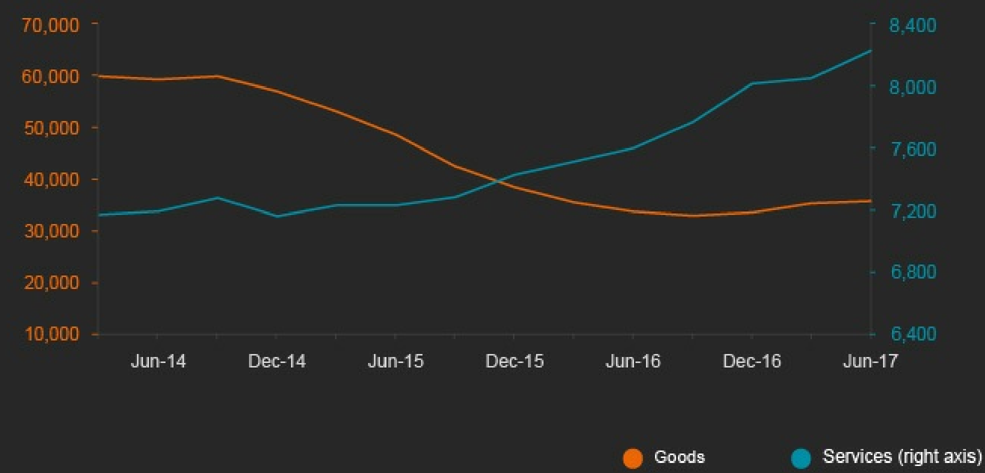
## 2. Exports of Services and other Current Income

Exports of Goods | Exports of Services | Annex

Exports of services have registered a positive variation in recent years (Graph 6), driven mainly by the recovery of the activities linked to tourism and business services. Indeed, between 2013 and 2016, total exports of services increased 14%, moving from USD $7,022 m to USD $8,007 m. These dynamics are largely explained by tourism revenues, which increased 23% in that period and was equivalent to 73% of total services exported in 2016 (*vis-à-vis* 68% in 2013), exceeding the value of exports of traditional goods such as coal, gold, coffee, and flowers (Graph 7). All of them have benefited from the accumulated depreciation of the peso and a better perception of security conditions in the country.

*Graph 6*
**Accumulated Exports of Goods and Services**

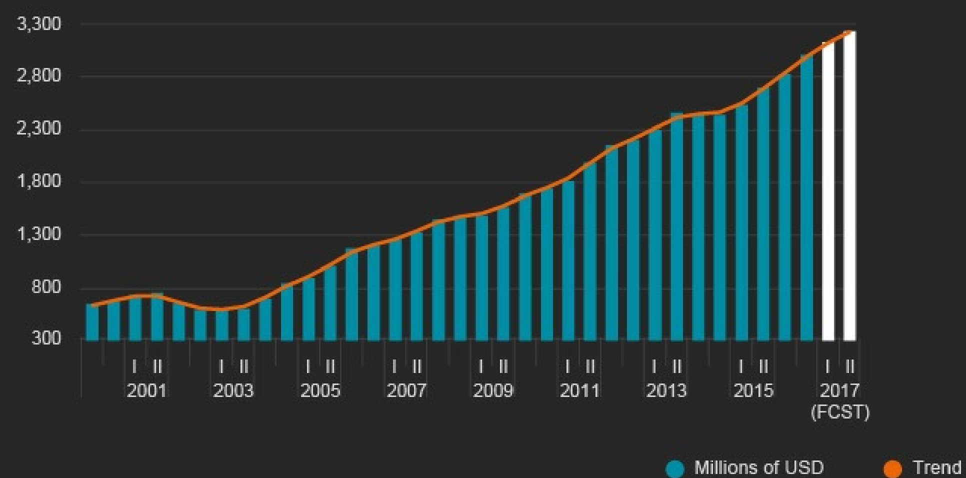
(Millions of USD, last 4 quarters)




Source: DANE, *Banco de la República*.

*Graph 7*
**Income from Tourism**

(Millions of USD, six-monthly figures)




(FCST): forecast.
Note: Seasonally adjusted data. Holidays and Easter holiday are adjusted whenever significant.
Includes the expenditure for travel by foreigners in Colombia and the income from passenger transport.
Estimate for 2017 based on the last forecast of the Balance of Payments presented in the Inflation Report.
Source: DANE, *Banco de la República*.

These dynamics are expected to continue in 2017 and in the following years. As a matter of fact, in the first half of 2017, revenues from travel increased 4.0% annually, and those from business services 17%. These figures underscore the country's potential as a supplier of services, as well as the need to develop the required infrastructure and logistics, and to improve our human capital (for example, encouraging bilingualism) in the sector.

Current transfers have also exhibited a good behavior in the last two years. After falling between 2013 and 2014, they have shown sustained growth, reaching USD $5,845 million in 2016, i.e., USD $1,224 m higher than in 2014. Transfers have been driven by workers' remittances from countries that are at last beginning to grow, such as the United States and Spain. Workers' remittances increased by 13% in January - July compared to the same period last year.

Revenues from Colombian investment abroad also increased, from USD $3,624 million in 2013 to $4,990 million in 2016. Two thirds of this variation is explained by the higher profits of Colombian enterprises with direct investment abroad; the rest is associated to the increase in revenues from portfolio investment and reserve assets. It should be noted that domestic companies have preferred to invest in nearby countries with which they share common socio-cultural and institutional environments. For this reason, they have been called *multilatinas*. Additionally, the economic activities that have concentrated foreign investment have been the most dynamic and those with the fastest expansion in recent years. The countries of the Pacific Alliance (Peru, Mexico, and Chile) plus Central America have been the destinations preferred by Colombian entrepreneurs to expand their direct investments. Colombian companies have focused their investments in the banking, insurance, and retirement funds sectors, as well as in cement and food production, electrical energy supply, and commerce. Greater profits have come together with a 33% increase in foreign stocks, while implicit profitability was close to 7.0% during the last years.

## STATISTICAL ANNEX