Monetary Policy Report - July 2021

Report Box 1 - Characterizing and Communicating the Balance of Risks of Macroeconomic … Box 2 - Analysis of Recent Disturbances in Global Logistics Chains and their Im… Box 3 - The Upward Dynamics of Food Prices Principales variables del pronóstico macroeconómico (Only available in Spanish) Keep in mind
The Monetary Policy Report presents the Bank's technical staff's analysis of the economy and the inflationary situation and its medium and long-term outlook. Based on it, it makes a recommendation to the Board of Directors on the monetary policy stance. This report is published on the second business day following the Board of Directors' meetings in January, April, July, and October.

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Starting in October 2019, the quarterly Inflation Report produced by the technical staff of the Central Bank will be known as the Monetary Policy Report. The document, which is used for the technical staff´s monetary policy recommendation, will be published on the working day after the meeting of the BDBR in January, April, July, and October, simultaneously with the Board minutes.

Publication Date: Thursday, 7 of October 2021 1.1 Macroeconomic summary
The Colombian economy sustained numerous shocks in the second quarter, primarily related to costs and supply. The majority of these shocks were unanticipated or proved more persistent than expected, interrupting the recovery in economic activity observed at the beginning of the year and pushing overall inflation above the target. Core inflation (excluding food and regulated items) increased but remained low, in line with the technical staff's expectations. A third wave of the pandemic, which became more severe and prolonged than the previous outbreak, began in early April. This had both a high cost in terms of human life and a negative impact on Colombia's economic recovery. Between May and mid-June roadblocks and other disruptions to public order had a significant negative effect on economic activity and inflation. The combination and magnitude of these two shocks likely led to a decline in gross domestic product (GDP) compared to the first quarter. Roadblocks also led to a significant increase in food prices. The accumulated effects of global disruptions to certain value chains and increased international freight transportation prices, which since the end of 2020 have restricted supply and increased costs, also affected Colombia's economy. The factors described above, which primarily affected the consumer price index (CPI) for goods and foods, explain to a significant degree the technical staff's forecast errors and the increase in overall inflation above the 3% target. By contrast, increases in core inflation and in prices for regulated items were in line with the technical staff's expectations, and can be explained largely by the elimination of various price relief measures put in place last year. An increase in perceived sovereign risk and the upward pressures that this implies on international financing costs and the exchange rate were further considerations.

Despite significant negative shocks, economic growth in the first half of the year (9.1%) is now expected to be significantly higher than projected in the April report (7.1%), a sign of a more dynamic economy that could recover more quickly than previously forecast. Diverse economic activity figures have indicated higher-than-expected growth since the end of 2020. This suggests that the negative effects on output from recurring waves of COVID-19 have grown weaker and less long-lasting with subsequent outbreaks. Nevertheless, the third wave of the coronavirus, and to an even greater degree the previously mentioned roadblocks and disruptions to public order, likely led to a decline in GDP in the second quarter compared to the first. Despite this, data from the monthly economic tracking indicator (ISE) for April and May surpassed expectations, and new sector-level measures of economic activity suggest that the negative impact of the pandemic on output continues to moderate, amid reduced restrictions on mobility and improvements in the pace of vaccination programs. Freight transportation registers (June) and unregulated energy demand (July), among other indicators, suggest a significant recovery following the roadblocks in May. Given the above, annual GDP growth in the second quarter is expected to have been around 17.3% (previously 15.8%), explained in large part by a low basis of comparison.

The technical staff revised its growth projection for 2021 upward from 6% to 7.5%. This forecast, which comes with an unusually high degree of uncertainty, assumes no additional disruptions to public order and that any new waves of COVID-19 will not have significant additional negative effects on economic activity. Recovery in international demand, price levels for some of Colombia's export commodities, and remittances from workers abroad have all performed better than projected in the previous report. This dynamic is expected to continue to drive recovery in the national income over the rest of the year. Continued ample international liquidity, an acceleration in vaccination programs, and low interest rates can also be expected to favor economic activity. Improved performance in the second quarter, which led to an upward growth revision for all components of spending, is expected to continue, with the economy returning to 2019 production levels at the end of 2021, earlier than estimated in the April report. This forecast continues to account for the short-term effects on aggregate demand of a tax reform package along the lines of what is currently being proposed by the national government. Given the above, the central forecast scenario in this report projects growth in 2021 of 7.5% and in 2022 of 3.1% (Graph 1.1). In this scenario, economic activity would nonetheless remain below potential. The noted improvement in these projections comes with a high degree of uncertainty.

Annual inflation increased more than expected in June (3.63%) as a result of changes in food prices, while growth in core inflation (1.87%) was similar to projections. The increased CPI for foods would be expected to persist for the remainder of the year, contributing to inflation remaining above the target. Overall and core inflation would be expected to return to close to 3% at the end of 2022, amid a deceleration in growth in the CPI for foods and reduced excess productive capacity. Recent increases in international freight and agricultural goods prices, as well as the livestock cycle and increased meat exports, have exerted upward pressure on food prices, primarily in processed foods (see Box 21). In addition to these persistent factors affecting prices, national roadblocks and related disruptions to public order in several cities throughout May and parts of June were reflected in a significant restriction of supply and an unexpected annual increase in the CPI for foods (8.52%). Inflation in regulated items (5.93%) also accelerated, due to a low basis of comparison on gasoline prices and the partial lapse of relief measures on utility rates that were put in place in 2020. Inflation excluding food and regulated items recovered in line with projections to 1.87%, due to the reinstatement of indirect taxes on certain goods and services that had been temporarily eliminated in 2020, and to upward pressures exerted by prices for foods away from home (FAH), among other factors. The increase in perishable foods prices is expected to be reversed over the course of the year, assuming an absence of additional, long-lasting blockades of national roads. Increased processed food prices would be expected to persist and contribute to keeping inflation above the target at the end of the year. Inflation excluding foods and regulated items is expected to continue to exhibit an upward trend, as excesses in productive capacity continue to close, and register a temporary increase in March 2022 largely due to the reinstatement of the FAH consumption tax. Given the above, overall year-end inflation is expected to be 4.1% in 2021 and 3.1% in 2022 (Graph 1.2), and

core inflation is expected to be 2.6% in 2021 and 3.2% in 2022 (Graph 1.3).

The technical staff has interpreted the overall behavior of prices in the CPI excluding food and regulated items, alongside continued unexpected increases in economic activity, as signs of more ample excess productive capacity in the economy. This would be expected to persist over the next two years, with the output gap closing at the end of that period. Increased economic growth suggests a less negative output gap than estimated last quarter. Nevertheless, the behavior of core inflation, especially in services, suggests that potential GDP has recovered to an unanticipated degree and that ample excess capacity continues, with a persistent effect on aggregate demand. Labor market observation supports this interpretation, with persistent high levels of unemployment and stagnation in the recovery of jobs lost as a result of the pandemic. Increased inflation can be explained largely by shocks related to costs and supply, and by the dissolution of some price relief measures put in place in 2020. The growth and inflation forecasts described above would be consistent with a less negative output gap closing more quickly across the forecast horizon compared to the projection from the April report. Nevertheless, uncertainty surrounding excess capacity is very high and constitutes a risk to the forecast (Graphic 1.4).

The fiscal accounts outlook deteriorated, Standard and Poor's Global Ratings (S&P) and Fitch Ratings (Fitch) downgraded Colombia's credit rating, roadblocks and disruptions to public order affected output, and the country faced a third wave of COVID-19 that was more severe and prolonged than the previous outbreak. These factors were reflected in an increased risk premium and depreciation of the peso compared to the dollar. This occurred in a favorable context in regard to foreign income, as international prices for oil, coffee, and other Colombian export goods increased. This contributed to a recovery in the terms of trade and in the national income and mitigated upward pressures on the risk premium and the exchange rate. Expected oil prices in this report are USD 68 per barrel (previously USD 61/bl) for 2021 and USD 66/bl (previously USD 60/ bl) for 2022. This increased trajectory shows convergence to oil prices below recently observed levels, as a result of increased global supply that would more than offset increased demand. As a result, the recent price increase is expected to be temporary.

International financial conditions are expected to become somewhat less favorable in the current macroeconomic context, despite the improvement in foreign income due to increased demand and some higher prices for oil and other export products. Growth in foreign demand was better than expected in the previous report, with projections for 2021 and 2022 increasing from 5.2% to 6.0% and from 3.4% to 3.5%, respectively. For the year to date, figures for economic activity suggest more dynamic foreign demand than previously expected. Output recovery has been faster in the United States and China than in Latin America, as economic reactivation in the latter has been limited by outbreaks of COVID-19, restricted vaccine supplies, and a lack of fiscal space to confront the pandemic, among other factors. The positive dynamic in foreign goods trade has come amid a deterioration in value chains and a significant increase in commodities and freight prices (see Box 3). Inflation in the United States has been unexpectedly high, with observed and expected values remaining above the target, while growth forecasts have been revised upward. As a result, the beginning of a normalization in monetary policy in the U.S. could come earlier than previously projected. This report estimates that the U.S. Federal Reserve's first rate increase will come at the end of 2022 (before the first quarter of 2023). Colombia's risk premium is projected to be higher than forecast in the April report, and is expected to remain on a growth trajectory given the country's accumulation of public and external debt. This would be expected to contribute to an increase in international financing costs on the forecast horizon.

An expansionary monetary policy stance continues to support favorable domestic financing conditions. The interbank rate and the reference banking indicator (IBR)remained consistent with the policy interest rate in the second quarter. Average deposit and credit rates continued at historical lows, despite some observed increases at the end of June. The peso-denominated credit portfolio continued to decelerate in annual terms and, between March and June, growth in the household credit portfolio accelerated, primarily related to housing pur-

chases. Disbursements and recovery in the commercial credit portfolio were significant, returning to high levels observed one year ago, when businesses required significant levels of liquidity to confront the economic effects of the pandemic. Meanwhile, credit risk increased, liability provisions remained high, and some banks withdrew from the balance of their past-due portfolios. Nevertheless, financial system earnings have recovered, and liquidity and solvency levels remain above regulatory minimums.

Beginning with this report, a new methodology will be used to quantify and communicate the uncertainty surrounding central macroeconomic forecasts in the context of an active monetary policy. The new methodology, known as predictive densities (PD), will be explained in detail in Box 1. PD methodology provides probability distributions of the main forecast variables (e.g. growth, inflation) based on the balance of risks of key factors that, in the technical staff's judgment, could affect the economy on the forecast horizon. These distributions reflect the result of possible shocks (to external variables, prices, and economic activity) that the economy could sustain and the transmission effects considering Colombia's economic structure and anticipated monetary policy responses. As a result, PD allows for the quantification of uncertainty around the central forecast and of its bias.

In this report, the PD exercise shows a downward bias for both economic growth and output gap, while the opposite is shown for headline inflation (Graphs 1.1, 1.2 and 1.3). The balance of risks indicates more complex monetary policy dilemmas than previously expected. The most significant anticipated risk regarding external financing would be a return to less favorable conditions in a scenario in which the U.S. Federal Reserve promptly raises interest rates. Such a decision could come as the result of current levels of economic growth and higher-than-expected employment generating significant inflationary pressures on that country. Uncertainty regarding Colombia's fiscal outlook and the subsequent effects on the risk premium and external financing costs represent additional considerations. The risks to economic growth are mainly downside risks, relating especially to the effects of political and fiscal uncertainty on consumption and investment decisions and the potential for additional waves of COVID-19 and the subsequent effects on economic activity. Inflation risks take into account the potential for more persistent shocks associated with disruption to value chains, higher international commodity and food prices, and a slower-than-expected recovery in the national agricultural chain as a result of the recent roadblocks. These would represent upward risks primarily to food and goods prices. The main downside risk to the inflation forecast would come from an increase in rental housing prices below the central scenario projection. This would be explained by weak demand and increased supply in 2022 as a result of high observed housing sales this year. All told, the PD exercise reveals a downward bias for economic growth forecast, with 90% probability of growth between 6.1% and 9.1% for 2021 and between 0.5% and 4.1% in 2022. The output gap also exhibits a downward bias to the central forecast scenario, primarily in 2022. On the contrary, an upward bias is expected for headline inflation forecast, with 90% probability ranging between 3.7% and 4.9% in 2021 and between 2.2% and 4.7% in 2022.

1.2 Monetary policy decision

In its meetings in June and July the BDBR left the benchmark interest rate unchanged at 1.75% (Graph 1.5).

Boxes

Box 1 - Characterizing and Communicating the Balance of Risks of Macroeconomic Forecasts: A Predictive Densities Approach for Colombia

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Box 2 - Analysis of Recent Disturbances in Global Logistics Chains and their Impact on Colombian Import Markets.

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Box 3 - The Upward Dynamics of Food Prices

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