Board of Directors of Banco de la República presents its Report to Congress and to the Public

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The macroeconomic scenario in Colombia changed substantially between 2020 and 2021. While some of the consequences of the Covid-19 pandemic are behind us, problems and imbalances persist and currently pose difficult challenges for economic policy. The pace of recovery in economic activity has been relevant. After a 7.0% GDP contraction in 2020, the Colombian economy expanded 10.6% in 2021, thus exceeding the technical staff's forecasts and market analysts' expectations, also ranking among the strongest in the region. This rebound in economic activity was fueled by the strengthening of domestic demand, driven by total consumption and, to a lesser extent, by the expansion of gross capital formation. Net exports reduced this momentum due to a faster increase in imports than in exports. Thanks to this good performance, the GDP level at the end of 2021 was higher than the pre-pandemic level. This was reflected in the improvement exhibited in the labor market that has, however, come about at a slower pace than that of productive activity. As of December, about 80% of the jobs lost between February and April 2020 had been recovered.

Available indicators for the beginning of 2022 show that the economy will sustain the momentum it had at the end of last year. The economic growth indicator (EGI) for January showed an annual growth of 7.8%, which is still an outstanding rate although somewhat lower than in December. Likewise, the monthly industry and commerce survey showed that the manufacturing industry presented a 15.1% annual change in January, and the real sales of total retail trade reached an annual growth of 20.9%. The technical staff's forecast for 2022 points to a 4.3% growth figure, which could be revised upwards based on the most recent information.

Along with the economic recovery, some imbalances have drawn the attention of the Board of Directors of *Banco de la República* (BDBR). One of them is the increase in the balance of payments current account deficit that went from 3.4% of GDP in 2020 to 5.7% in 2021. This greater imbalance largely originated in the expansion of domestic demand, which was not fully met by local supply. In addition, the higher profits that companies with foreign capital remit abroad enlarged the net factor income deficit. In the absence of corrective measures, the current account deficit for 2022 is projected to be around 4.9% of GDP. Nevertheless, this forecast is subject to a high degree of uncertainty given the recent war in Ukraine, which has had a significant impact on the international prices for commodities including crude oil. Financing this imbalance is likely to be a more difficult process than it has been in recent years given the context of tightening international financial conditions.

The most demanding challenge the BDBR currently faces is controlling inflation, which, after falling to 1.61% in 2020 as a result of weakening demand, acquired an upward trend as of May 2021 that took it to 5.62% at the close of the year. This trend continued during the first two months of this year and reached 8.01% in February. Unlike past inflationary episodes, which were mostly due to climatic factors, this time the main cause of the increase in inflation has originated abroad, making it especially unpredictable. This pressure from abroad stemmed from the strong rebound in global economic growth, which exceeded the response of many productive sectors affected by the pandemic and overwhelmed the logistical capacities of maritime shipping and storage. This produced a significant increase in international freight rates which, along with other factors, affected global supply chains. As a result, there was a widespread increase in the prices of agricultural and industrial supplies and of commodities that has been more persistent than originally anticipated, and which ended up being passed on to consumer prices. The increase in international prices is currently reflected in a historically high inflation practically around the world, a phenomenon which Colombia has not escaped from. The conflict generated by the Russian invasion of Ukraine has further aggravated the global commodity supply crisis since these two countries play a significant role in it. Therefore, an additional impact on international prices for food and supplies for agricultural production is expected.

As explained in detail in the body of the March *Report*, in the Colombian case, higher international inflation and the resulting increase in production costs have been reflected in a significant increase in food price inflation, for which the twelve-month change exceeded 23% in February. There were also internal factors related to problems of public order and the blockages of roads in May and June 2021 that generated shortages of supplies and hampered production processes in some branches of the economy in the medium term. Another factor putting pressure on consumer prices has come from higher inflation in regulated goods and services that resulted from international increases in energy prices. This caused increases in fees for urban transportation, electricity, gas, and fuel for vehicles, to which was added the gradual dismantling of the utility rate relief granted by the government during the most critical period of the pandemic.

This pressure on prices occurred in the context of strengthening of domestic demand, especially since mid-year, as it registered a 13.3% annual expansion in 2021 that more than offset the 7.5% contraction seen in 2020. The rapid growth of domestic consumption that was driven mainly by higher household consumption and closely followed by the growth of public consumption was the main engine of demand recovery. Investment added to the boost in demand by achieving a significant rebound, particularly in housing and machinery and equipment. In the context of the rapid increase in spending, the lag in the response of aggregate supply affected by the aftermath of the pandemic, the strike, and roadblocks in mid-2021 contributed to the emergence of excess demand that put considerable additional pressure on the prices of various components of the family basket and were reflected in the expansion of the foreign debt.

Monetary policy response has been framed within the constitutional mandate to ensure that the purchasing power of the currency is maintained, in coordination with the general economic policy. Due to the enormous economic shock of the pandemic in 2020, the BDBR used a variety of instruments at its disposal to stabilize the economy and stimulate its recovery as described at length in the two 2021 *Reports to Congress*. In particular, it reduced the policy interest rate to 1.75% in September 2020, its lowest historical level in both nominal and real terms. This was supplemented by an abundant supply of liquidity to preserve the payment system and encourage credit. In addition, foreign exchange hedging mechanisms and access to liquidity in dollars were adopted to stabilize the foreign exchange market. In the context of a stable financial system and access to credit (despite the uncertainty due to the continuing pandemic), the recovery of economic activity during 2021 is the best proof that this package of measures adopted in a timely manner by the BDBR met its objectives.

The remarkable recovery of the gross domestic product (GDP), which approached its potential level over the course of 2021, above-target inflation, and the expansion of the current account deficit to levels that reflected significant excess demand with respect to domestic production prompted the Board to start a new phase of the monetary policy stance. In this new scenario, a smaller monetary stimulus than the one granted during the critical period of the pandemic was required, otherwise macroeconomic stability and compliance with the mandates assigned to the Central Bank by the National Constitution would have been jeopardized. Based on this reasoning, the BDBR unanimously decided to initiate a process of monetary policy normalization as of September 2021. One important factor was to moderate inflation expectations since their possible decoupling from the 3.0% target would deepen price and wage indexation at high inflation rates and make it much more costly to regain control of inflation in terms of economic activity.

As part of the normalization process, the policy interest rate went from 1.75% in September last year to 4.0% in January. This increase will induce upward adjustments in the financial system's deposit and lending rates through a transmission process that may take several months. The speed and magnitude of response differs depending on the instruments and types of credit. This implies that the effect of monetary policy on inflation and other macroeconomic variables such as savings and spending does not occur immediately. This explains why, during the process of monetary policy normalization, the inflation rate will continue to increase. This was the case during the first two months of the year when it reached 8.01% per annum in February after having closed the previous year at 5.62%.

The February inflation figures showed a characteristic fact of the effect that higher inflation expectations can have on price variation. This is what happened with core inflation, which is defined as that which affects the set of goods and services in the family basket excluding food prices and those for regulated goods and services. This measurement of inflation, which stood at 2.49% (sufficiently below the target) in December, registered a level of 4.11%, which is equivalent to a 162 basis-points (pb) increase over a period of only two months in February. The fact that this happened with an indicator of inflation that does not include food or regulated products, the two items that have pushed inflation upward the most, shows to what extent inflationary pressure is beginning to be transferred to other components of the basket. This occurs through a price indexation process induced by an increase in inflation expectations in a context where past inflation and minimum wage increases were high as well, as well as by domestic demand, which remains strong as shown by the aforementioned retail sales indicators. The other core inflation indicators also increased during the first two months of the year, such that their average went from 3.45% in December to 5.22% in February.

The BDBR is aware that policy rate increases will not contain inflationary pressure coming from sources abroad. It is clear that the external price pressure that has been occurring in recent months will only be corrected as supply chains normalize. However, a fundamental step toward achieving the convergence of Colombian inflation with the target is the effort of monetary policy to stop the rise of inflation expectations and the so-called "second round effects” on inflation of all those products with prices that are determined domestically in Colombia and that are indirectly affected by external pressures in the context of strong aggregate demand.

As was mentioned, the complex panorama left by the Covid-19 pandemic is compounded by the conflict between Russia and Ukraine which, apart from being a humanitarian tragedy, generates serious consequences for the world’s economy. The uncertainty and volatility of international markets as well as the shock to investor and consumer confidence will delay the global economic recovery. From the Colombian point of view, the pressure that could be exerted on food prices is of particular concern since the country imports a significant amount of grain, the prices of which will be affected by the reduction in supply, which has traditionally been met to a significant extent by the region where the conflict is taking place, and which is used to feed pigs and chickens. Likewise, imported fertilizers, especially urea, from these countries are indispensable materials for agricultural production. As a result, the increase in their prices will become an additional inflationary pressure on the country. Moreover, the blockade on Russia reduces the supply of oil and increases its price, which is already at historically high levels. While this could have a favorable effect on the external balance and the country's national and territorial public finances in the short term, higher energy costs will increase upward pressure on many imported raw materials and on local fuel prices. The latter has a negative impact on the Fuel Price Stabilization Fund (FEPC, in Spanish), as it would force it to increase its shortages in its effort to moderate increases in final consumer fuel prices. Paradoxically, Colombia could see its external financing needs alleviated to a certain extent, to the degree that investment funds that are forced to stop investing in Russia reallocate their portfolios to other emerging economies including Colombia.

The issues mentioned above will be developed in greater depth in the March 2022 Report of the Board of Directors to the Congress of Colombia.