



**Banco de la Republica  
Division of Economic Studies**

**Description of the foreign context that the Colombian economy faces, the change in foreign trade, performance of domestic demand, output, and credit as well as the performance of inflation and inflation expectations.**

## **I. Foreign Context, Exports, and Imports**

1. Based on the figures as of May, the global economy is remaining on its path to recovery. The advanced countries are consolidating their emergence from the recession but their growth rate is relatively weak and, therefore, they have not reached the level of activity they had in 2008. The emerging economies, in turn, are slowing down. However, note that the recent figures suggest that the growth of the Chinese economy is stabilizing.

2. After the shrinking of the US GDP in the first quarter of 2014, the May information shows that productive activity surged in the second quarter. The growth of retail sales was positive in both annual and monthly terms, and the sentiment indices in the manufacturing and service sectors were in expansionary territory. Regarding the labor market, the unemployment rate in May was again at 6.3% and the net creation of employment was above 200,000 job positions.

3. In spite of the positive performance of the US economy in the second quarter, analysts are lowering their growth predictions for the entirety of 2014 as a consequence of the weak performance at the beginning of the year.

4. In the euro zone, industrial production grew in April in both annual and monthly terms. In May, the business and consumer confidence indices continued their recovery and the sentiment indicators in the manufacturing and service sectors remained in expansionary territory. Everything seems to indicate that the economies in this region are acting the way the market and the technical team at the Bank expected them to.

5. In Japan, GDP growth surged in the first quarter of the year due to the more dynamic household consumption and investment. The upswing in taxes starting in April could explain the larger increase in household consumption since people were factoring it into their expenditures.

6. With respect to the emerging economies, the expansion of industrial activity as well as that of the retail sales and exports recorded for China in May show that the growth of that economy is beginning to stabilize. In contrast, Russia registered a timid expansion in the first quarter and its growth is expected to be barely positive in 2014. The crisis in Ukraine has affected the economic performance of the developing countries in both Europe and Central Asia.

7. In other Asian economies, the growth of production in the first quarter showed favorable signs although it ended up at levels that were lower than those that have been seen over the last decade. In Latin America, in turn, there was a slowdown in the annual expansion of the GDP in several countries. This was the result of the lower prices for some commodities and the poor performance of the US economy in the first quarter, etc.

8. Respecting the prices for commodities, in May and up to this point in June, the prices for petroleum remained above what the technical team had estimated for the 2014 average (US\$105 per barrel referenced to the Brent index published in the March 2014 Inflation Report). Nickel prices, in turn, continued rising while the prices for coal and coffee fell. In the case of the prices for imported products, those for wheat and corn declined while the prices for soybeans did not show much change.

9. With the exception of Japan, where the increase in taxes in April affected the cost of living, inflation in the main developed economies stayed at low levels, especially in the euro zone where the prices continued falling.

10. In the emerging economies, inflation continued to rise in some Latin American countries while it has stabilized in Asia.

11. In terms of monetary policy, the most important announcement was that made by the European Central Bank in reducing their benchmark interest rate and establishing a few monetary stimulus measures in an effort to act against deflation. The US Federal Reserve (Fed), in turn, maintained their posture of normalizing monetary policy.

12. The global financial markets have performed favorably over the last few weeks. The stock market indices appreciated and the risk perception declined. In Latin America, the risk premiums continued to drop while the exchange rates for the main currencies with respect to the dollar have shown contrasting trends. In the cases of Chile and Peru, there has been a certain amount of stability which contrasts with the ups and downs that have been seen in Brazil and the downward trend in Colombia. In the latter case, this is the result of the inflow of capital related to the changes in the JP Morgan benchmark portfolios. Nevertheless, the signs of better economic performance in the US and its effect on the expectations of an adjustment in the policy interest rates in that country make the future trend of the exchange rates in the region particularly uncertain.

13. In this context, the value of total exports in dollars registered an annual decline of 13.1% in April. This was due to the 13% drop in the main products from mining (petroleum and its derivatives, coal, nickel-iron, and gold), 13.8% in industrial products, 2.4% in the main agricultural goods (coffee, bananas, and flowers), and 52.7% in the remaining products.

14. In the exports from mining, petroleum derivatives registered the largest annual contraction (-38.7%) in April, and in the case of agricultural products, their performance is the result of that of flowers (-29%) and bananas (-34.7%). The performance seen in industrial products was due to the lower sales of the majority of the items with the exception of food and beverages and metal goods where the exports grew 14.4% and 12% respectively. The declines for chemical (-10.2%) and nonmetallic mineral (-32.9%) products were the most notable. In the case of these items, the importing countries that saw the largest contraction were Brazil (-37%) and Ecuador (-19.6%).

15. For the cumulative January-April period, the value of exports in dollars declined 6.8% in comparison to the same period last year. This was the result of drops of 7.8% in the main mining products, 8.2% in industrial products, and 14.7% in the remaining products. Foreign sales, in turn, of the most important agricultural goods grew 9.1% in annual terms, primarily due to coffee (15.6%) and bananas (18.2%). The lower industrial exports were largely because of the drops seen in vehicles (-49%), rubber and plastic (-20.7%), and textiles (-22.1%).

## **II. Domestic demand, growth, and credit**

16. The growth of the GDP was 6.4% in annual terms during the first three months of 2014. This figure was above the upper limit of the forecast range given in the previous Inflation Report (between 4.2% and 5.4% with the midpoint being 4.8%).

17. In addition, DANE revised the growth estimates for 2013 upwards. During that year, the GDP grew 4.7% and not 4.3% as had been reported. All of the quarters for last year were corrected upwards.

18. For the first quarter of 2014 in the area of supply, the strength of the construction; social, community, and personal services; and the agricultural sectors stand out with growths of 17.2%, 6.3%, and 6.1% respectively (Table 1). In the case of construction, the largest expansion occurred in public works (24.8%) although the increase in that of buildings was also significant (7.9%).

19. It is noteworthy that industry registered positive growth (3.3%) after two years of negative rates. This performance was due in part to the larger number of working days in the first quarter compared to the same period in 2013.

**Table 1**

**Annual Growth of the GDP with Respect to Supply**

Branch of activity	mar-13	jun-13	sep-13	dic-13	2013	Mar-14
<b>Agriculture, animal husbandry, hunting, forestry, and fishing</b>	3.1%	7.6%	5.2%	5.9%	5.5%	6.1%
<b>Mining and quarrying</b>	1.0%	4.3%	6.8%	7.8%	4.9%	5.6%
<b>Manufacturing</b>	-4.8%	1.1%	-0.2%	0.0%	-1.0%	3.3%
<b>Electricity, gas, and water</b>	4.4%	5.9%	4.0%	5.3%	4.9%	3.1%
<b>Construction</b>	11.1%	6.1%	23.3%	8.6%	12.0%	17.2%
Buildings	11.1%	11.9%	29.9%	-3.0%	11.4%	7.9%
Public works	11.3%	1.9%	18.8%	20.6%	12.7%	24.8%
<b>Commerce, repairs, restaurants, and hotels</b>	2.9%	4.3%	4.6%	5.5%	4.3%	5.6%
<b>Transportation, storage, and communications</b>	2.1%	3.2%	3.5%	3.5%	3.1%	4.5%
<b>Financial institutions [...]</b>	3.8%	4.6%	6.0%	5.7%	5.0%	6.0%
<b>Social service activities [...]</b>	5.0%	5.1%	5.0%	6.2%	5.3%	6.3%
<b>Value-added subtotal</b>	2.7%	4.3%	5.6%	5.2%	4.5%	6.3%
<b>Taxes minus subsidies</b>	3.8%	4.6%	5.7%	4.5%	4.7%	7.7%
<b>GROSS DOMESTIC PRODUCT</b>	2.9%	4.6%	5.8%	5.3%	4.7%	6.4%
<b>Gross Domestic Product (Published March 2014)</b>	2.6%	4.0%	5.4%	4.9%	4.3%	

Source: DANE, National Accounts

20. The GDP for non-tradables expanded at an annual rate of 7.1% while the one for tradables expanded at 5.4% in the first three months of the year. If the mining production is discounted from the latter, the increase would be 5.3% annually.

21. DANE has not published the GDP figures for the area of demand yet. However, the information available suggests that the surge in economic activity could be explained by the strength of domestic demand and, especially, by the investment component (as shown by the growth of the construction sector and the data on imports of capital goods for industry and agriculture).

22. The indicators available for the second quarter suggest that domestic demand and household consumption, in particular, are remaining strong. Nevertheless, lower growth is also anticipated in various sectors of the economy.

23. The information from the Monthly Retail Sample index (MMCM in Spanish) published by DANE shows that household purchases slowed down slightly in April compared to what had been registered in March. However, the growth registered as the average for the first three months of the year (7.2% in April compared to 8.3% in March and 7.2% in the first quarter) remains the same. The average for the March-April two-month period that corrects for the problem in the number of working days grew 7.8% in annual terms.

24. The Banco de la Republica's Monthly Survey of Economic Expectations (EMEE) for the month of April likewise revealed that those surveyed expected sales to be higher than those registered in the first quarter of the year.

25. The figures for vehicle sales published by Fenalco and Econometria suggest that the consumption of durable consumer goods will have registered a favorable performance in the second quarter. The growth rate for the April-May two-month period was 3.7% which corresponds to an increase of about 1,800 units sold in comparison to the same period in 2013.

26. In May, the consumer confidence index (CCI) published by Fedesarrollo rose with respect to the levels for the last few months and was above the averages for the first quarter, for all of 2013, and for the average since 2001. The economic conditions, and medium and long term expectations rose compared to their levels in April and March.

27. In addition, the consumer loan portfolio rose slightly in May for the second consecutive month. It went from growing 11.3% in annual terms in March to

11.5% in April and to 11.8% in May. Add to that the fact that the real interest rates have been showing a downward trend for several months due to the higher rates of inflation and remain below their historical averages (calculated since the year 2000).

28. The labor market indicators, in turn, continue to suggest that there are improvements in labor conditions. The growth of employment has stayed at acceptable rates in the last few months and is mainly concentrated in wage-earning jobs.

29. Regarding investment, the information from EMEE as of April suggests a slight slowdown in the formation of gross fixed capital apart from that related to the construction of buildings and public works projects.

30. In the area of supply, the industrial production index fell 2.2% annually in April which is less than had been expected by the Bank's technical team. In spite of this, the trend for the series maintained its expansionary path. Thus, the growth rates for the March-April two-month period and for the year so far were 3.2% and 2.6% respectively.

31. Cement production surged 15.9% in April. The trend for the series continues to show a rising slope which augurs well for the performance of the construction sector in the future. Deliveries also registered upswings of more than 10%.

32. In May, the total demand for electricity as well as that for non-regulated electricity registered increases. In the first case, it rose 4.8% (compared to 1.2% in April). Meanwhile, in the second, the expansion was 0.5%, a figure that is higher than the -3.3% registered in April for this item.

33. Petroleum production fell 6.8% in May in annual terms. This was the result of the attacks on the petroleum infrastructure that occurred during that month. These affected the pumping of crude oil through the Caño-Limon Coveñas and Bicentenario pipelines.

34. According to the information provided by the National Federation of Coffee Growers, the production of coffee jumped 12.1% in May in comparison to the same month in 2013. This figure indicates a recovery with respect to the levels of the last few months.

35. The above information suggests that the GDP could grow at a higher rate in 2014 than was predicted in the previous reports. Note that the technical team's forecast range for this growth presented in the previous quarterly report is between 3% and 5% with 4.3% as the most probable figure.

### **III. Trend of inflation**

36. The annual consumer inflation rose again in May and went to 2.93%. This is 21 basis points (bp) higher than what was registered the previous month (**Table 2**). This information, which in terms of monthly variation went to 0.48%, was higher than what had been expected by the market and the technical team at the Banco de la Republica. The main upward pressures came from food and from the group of amusement, culture, and recreation.

37. Core inflation also rose at this time. The average of the four indicators monitored by the Bank closed at 2.87%, which is 12 bp above what was registered the previous month. Three of the indicators rose with Nucleo 20 being the one that showed the highest level (3.1%) and was above 3.0% for the first time in 17 months. Inflation excluding food and regulated items, in turn, was very close to the midpoint of the target range. Only the CPI excluding food went from 2.9% in April to 2.8% in May.

38. The decline in annual inflation excluding food was concentrated in the CPI for regulated prices since the other two large components—tradables and non-tradables—surged. Within regulated items, this trend was due to the monthly declines in the fees for natural gas, intercity transportation, and to a lesser degree, electricity, all of which can be considered one time occurrences.



**Table 2****Trend of Inflation as of May 2014**

Description	jun-13	sep-13	dic-13	mar-14	abr-14	may-14	Percentage share in the upswing for the month	Percentage share in the upswing for the month
<b>Total</b>	<b>2.16</b>	<b>2.27</b>	<b>1.94</b>	<b>2.51</b>	<b>2.72</b>	<b>2.93</b>	<b>100.00</b>	<b>100.00</b>
<b>Excluding Food</b>	<b>2.48</b>	<b>2.36</b>	<b>2.36</b>	<b>2.62</b>	<b>2.85</b>	<b>2.76</b>	<b>-29.83</b>	<b>29.03</b>
Tradables	1.10	1.34	1.40	1.65	1.83	1.95	13.85	13.00
Non-tradables	3.78	3.70	3.76	3.55	3.51	3.68	25.02	-1.64
Regulated items	1.98	1.24	1.05	2.21	3.05	2.14	-68.71	17.67
<b>Food</b>	<b>1.34</b>	<b>2.05</b>	<b>0.86</b>	<b>2.23</b>	<b>2.39</b>	<b>3.35</b>	<b>129.83</b>	<b>70.97</b>
Perishables	2.44	5.94	-0.16	3.17	6.89	10.97	75.71	43.59
Processed	-11.00	0.18	-0.24	0.92	0.51	1.23	53.20	23.02
Meals away from home	3.51	3.74	3.26	4.13	3.73	3.75	0.91	4.37
Core Inflation Indicators								
Excluding food	2.48	2.36	2.36	2.62	2.85	2.76		
Nucleus 20	2.83	2.79	2.72	2.86	2.80	3.14		
CPI excluding perishables, fuel, and public serv.	2.14	2.19	2.19	2.53	2.54	2.63		
Inflation excluding food and regulated items	2.63	2.69	2.74	2.74	2.80	2.95		
<b>Average of first 4 indicators.</b>	<b>2.52</b>	<b>2.51</b>	<b>2.51</b>	<b>2.69</b>	<b>2.75</b>	<b>2.87</b>		

Source: DANE, Banco de la Republica calculations

39. The annual change in the CPI for non-tradables went to 17 bp (to 3.7%) after declines during the two previous months. The bulk of this upswing was concentrated in the group of amusement, culture, and recreation and, specifically, the item associated with tickets for soccer games. These rises usually coincide with the finals for the national tournament which was moved up from June to May this year. Taking into account what has happened in the past, a large percentage of said rises could reverse in the coming months.

40. With respect to the CPI for rent, there was an annual change of 3.4% which was a 9 bp decline in comparison to what was registered in April. This indicator, which has been showing a downward trend with a few interruptions for 20 months, represents 18.6% of the total CPI basket and corresponds to 60% of the group of non-tradables excluding food and regulated items.

41. For the group of tradables excluding food and regulated items, the annual change in the CPI surged again in May and closed at close to 2.0%. This level is still the lowest in comparison to the rest of the main components of the CPI. The cumulative depreciation as of March 2014 has continued to be transmitted to consumer prices in spite of the fact that, in the last three months, the peso has tended to become stronger. Note that, according to the Banco de la República's models, the pass through of the exchange rate movements to consumer prices takes between one and two quarters in the absence of other pressures. Over the last month, increases in the level of prices for vehicles, alcoholic drinks, some cleaning articles for the house, and some medicine, etc. have been continuing.

42. With respect to the CPI for food, its annual change in May was 3.4% having surged 100 bp in comparison to April and above what had been expected by the technical team at the Bank. This is the largest jump from one month to another for this indicator since September 2011. At that time, upswings in a broad range of products were seen led by perishable foods from agriculture for which there was an annual change of more than 300 bp. This has accentuated the upward trend that started towards the end of the fourth quarter last year. A portion of these increases may have been caused by the normal supply cycle of these products and be a reaction to the low relative prices registered in the second half of last year.

43. Other food items that also increased in price during the last month were meat, eggs, and milk products. In the case of imported food items (oil and grain, excluding rice) the upswings remained very moderate. The CPI for meals away from home saw an annual change of close to 3.8%, which is similar to that registered in the previous month.

44. Based on the monthly survey given by Banco de la República to market analysts during the first week of June, the inflation expectations for the end of 2014 as well as those calculated for the next twelve months have kept growing. This time, the respective values were 3.4% and 3.2%. Values that are above the midpoint of the target range have been recorded since April. The expectations derived from the TES yield curve also rose, but to a lesser extent.

45. Non-labor costs have shown little variation due to the trends in the PPI. The annual change in this index was 3.1% in May, which is lower than what was registered the month before (3.4%) resulting in a negative monthly change (-13 bp). To a large degree, this reduction is the result of the performance of the PPI for imported items which is associated with the appreciation of the peso over the last three months. The pass through of the exchange rate to the wholesale prices was

higher and took place with a shorter lag than in the case of the CPI. In addition, the PPI for items produced and consumed locally also showed a decline in its annual change that was due to the agricultural component (including and excluding coffee), which contrasts with the trend registered for the CPI of food items.

46. Based on the information available, labor costs do not suggest significant upward pressure either on the inflation rate so far this year. In the case of the wages received by construction workers, the figures for May show that these were adjusted to an annual rate of about 4.0%. In the areas of industry and trade, the data for April reveals that the pace of adjustment was lower once it is corrected for the number of working days. It should be noted that the reduction of the employer's contribution to health insurance (8.5%), which went into implementation this year, may partly cushion the effect of rising wage costs, at least during 2014.