



**BANCO DE LA REPÚBLICA
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 new official figures, the gross domestic product (GDP) for the United States in the first quarter of 2014 was somewhat lower than what had been registered three months before. The adverse climatic conditions and less inventory accumulation compared to the high levels during the immediately preceding period are the reason for a large part of this. Thus the official growth for the first quarter was -1.0% annualized quarterly (a/q) instead of the 0.1% a/q published a month ago. In addition to the preceding, the new figure also reflected the negative contribution of net exports, the investment in fixed assets, and government expenditures. In spite of that, household consumption continued to expand at a favorable rate.

2. The information available for the second quarter suggests that the United States economy is continuing to recover. On one hand, the negative effect of economic activity resulting from the lower inventory accumulation is expected to dissipate over the next few months. On the other hand, the numbers from April for industrial and retail sales grew in annual terms while the opinion and confidence indices went to levels that suggest that the economy is still becoming stronger. In the labor market, the unemployment rate dropped in April. This time it was accompanied by a surge in the creation of employment.

3. According to the most recently published minutes of the Federal Reserve, the majority of those who are on the monetary policy committee expressed their concern about the sluggish recovery of the housing market and its effect on the recovery of economic activity. Among the factors that could explain this phenomenon, they mentioned the high prices, bottlenecks in the construction sector (due to the lack of labor/workers), increases in the costs of supplies, more limited availability of land.

4. In the euro zone, the GDP expanded at a modest rate in the first quarter of the year. The greater strength in Germany and Spain was counteracted by the lack of growth in France and contraction in Italy. In April, business and consumer confidence continued to recover while the activity indices in the manufacturing and service sectors stayed in expansionary territory. Nevertheless, factors such as the difficulties in the labor market and financial fragmentation continue to impede a faster recovery.

5. With respect to the emerging economies, productive activity in China continued to slow down and for the entire year, its growth could end up below the 7.5% target set by the government. In April, the indicators for industry, retail sales, and investment in fixed assets continued to show lower rates of growth. In the case of the first two, the slowdown turned more moderate. The risks in their real estate market are still rising.

6. In Latin America, the terms of trade remained below the levels seen in 2010-2012. Exports, likewise, remained weak. In spite of this external shock, which affected all the countries, some factors that are specific to each economy caused each economic cycle to be desynchronized and its position (measured by the output gap) to be distinct in the short term.

7. Thus for Chile and Brazil, the growth forecast made by the IMF and analysts suggested a slowdown in contrast to Mexico where productive activity is recovering. For Colombia and Peru, growth that is similar to what was seen in 2013 is expected.

8. Regarding the international prices for some commodities exported by the country, the prices for petroleum remain above what the technical team expected to be the average for 2014. A sharp rally in the price of nickel has also been seen in the last few weeks. Prices for coffee and coal, in turn, declined.

9. In the case of some imported agricultural goods such as wheat and corn, declines in the international prices have been registered in recent weeks.

10. In the first quarter of 2014, the terms of trade (trade methodology) dropped 6.9% annually. This was the result of the lower export prices for the main products from mining and coffee. This trend continued in March when they fell 4.4%.

11. Respecting inflation, this remains at very low levels in Europe and, therefore, the risk of deflation continues. Under these circumstances, the European Central Bank announced in May that, over the next few months, they might take measures to counteract the deflationary risks in the region. In April, a significant resurgence of inflation was also seen in the United States. The Federal Reserve continued cutting back on their purchases of financial assets.

12. With respect to the emerging economies, rises in inflation continue to be seen in Latin America while it has remained relatively stable in Asia. In recent weeks, the monetary posture of this group of countries has not changed.

13. Regarding financial markets, the long term interest rates in the United States declined. The stock markets of the emerging economies, in turn, have appreciated recently and have recovered part of what they had lost at the beginning of the year. In Latin America, the perception of risk has eased off and the exchange rates have appreciated in comparison to the US dollar.

- Exports and Imports

14. In March, total exports fell 4.5% compared to a year ago. This was because of the 7.7% drop in mining exports. The larger contributions to this fall came from the exports of derivatives (-36.8%) and gold (-34.5%) due to a decrease in both the price and the quantity exported. Foreign sales of the main agricultural products, in turn, (coffee, bananas, and flowers) grew 10.9%, especially due to the larger volumes dispatched. Other agricultural exports together with those of industrial goods presented their first inter-annual rise (1.5% annually). The main destinations were Mexico, Ecuador and the United States which saw increases of 26.2%, 9.7%, and 5.9% respectively. This performance is due, in large part, to the growth in the areas of food and beverages (24.6%) and chemical products (10.7%).

15. With the above, total exports in dollars in the first quarter of 2014 registered an annual decline of 4.6%. This reduction was due in large part to the lower prices for the main export products. Exports of mining products and industrial goods (including some agricultural products) dropped an annual 6.1% and 5.4% respectively. Foreign sales of the main agricultural products, in turn, jumped 14.2% due to an increase in the amount of coffee.

16. In March, total imports rose 9.4% in comparison to the same month last year. Higher imports of intermediate (24%) and consumer (5.2%) goods contributed to this performance while purchases of capital goods registered a 5.2% drop. In the first case, note the combined increase in purchases abroad of raw materials for industry (21%), fuel and lubricants (30.4%), and raw materials for agriculture (26.7%). In the case of consumer goods, upswings were registered for both durable (8.3%) and non-durable (1.9%) goods. With respect to capital goods, the drop in the category of airplanes is the cause of the decline. When this area is excluded, the growth in capital goods was 3.2%.

17. The accumulated dollar value of imports for January to March 2014 rose 4.2% annually. In general terms, this performance was associated with the increase in the quantities imported which offset the decline in prices. The larger amount

imported was due to the 14.5% annual increase in the purchases of intermediate goods abroad, largely fuel and lubricants (30.4%). The latter item is related to the larger purchases of diluents for transporting heavy crude oil and diesel with a low sulphur content. In the case of capital goods, there was a drop of 5.4% resulting from the more limited purchases of aircraft. Purchases for consumption remained relatively stable (-0.2%).

II. Domestic demand, growth, and credit

18. The new figures available for the first quarter of 2014 confirmed the forecasts given in the last Inflation Report. The Colombian economy has grown at a rate of 4.8% which is similar to what was registered towards the end of last year (4.9%). This projection takes into account a private consumption that holds to a positive growth rate and assumes an investment in public works and in government expenditures which will slow down with respect to the fourth quarter of 2013.

19. According to the most recent information published by DANE, the positive dynamics of household consumption during said period has been ratified. Indeed, the retail sales index from the Monthly Retail Sample index (MMCM in Spanish) surged 8.3% annually in March. With this, the first quarter of 2014 saw 7.2% growth, a figure that is higher than what was registered for the fourth quarter of 2013 (5.2%). When vehicle sales are discounted, the increases were 5.9% for March and 5.0% for the quarterly average.

20. In the case of automobile sales, the annual rise was 19.7% in March. The aggregate for this consumer item grew 17.5% for the first quarter in comparison to the same period in 2013. It also registered a significant surge compared to what was seen towards the end of last year (1.9%). Note that the trend component for this series showed a favorable buoyancy during the first three months of the year.

21. Something similar can be inferred from the results of the Banco de la Republica's Monthly Survey of Economic Expectations (EMEE). In March, the balance of sales on the survey suggested that the expansion of household domestic consumption had occurred at a favorable rate during the first quarter based on what was suggested by the rest of the short term indicators.

22. The recent trends in the job market will continue to contribute to the growth of consumption. Based on information as of March, the unemployment rate continued dropping in cities and county seats, but it rose slightly in the rural areas.

When this is corrected for seasonality, the declining trend of this indicator is confirmed. The number of people holding jobs continues to rise, especially for those categorized as wage-earning, which are normally related to better income and greater job stability.

23. Investment other than investment in building construction and public works will also maintain a growth rate similar to the rate from last quarter. This is partly due to a low base of comparison from last year. Based on the figures from the balance of investment expectations found by EMEE as of March, businesses moderated their expectations of accumulating capital with the future in mind. Nevertheless, these remain at high levels. In contrast, the strength, in real terms, of imports of capital goods does not suggest additional surges like those that occurred in the last quarter of 2013.

24. Respecting supply, the new indicators show a favorable performance for sectors such as commerce, industry and construction.

25. The index of industrial production excluding coffee threshing that is calculated by DANE, rose 9.8% in annual terms in March. This figure is close to what was expected by Economic Studies Division (10.0%). When corrected for working days, the growth was 2.2%. With the record from March, industrial production excluding coffee threshing saw an annual expansion of 4.4% in the first quarter of the year. This is the highest figure for an entire quarter since 2011. When coffee threshing, which grew 39.4%, is included, the total for the sector rose 5.0% during this period.

26. With respect to construction, cement production showed an annual rise of 9.8% in the first quarter. The sales also showed significant strength (14%). Construction licenses, in turn, registered a growth of around 30% annually in March. The accumulated levels of the series at the end of twelve months rose slightly and maintained an expansion rate of close to 10%.

27. With the above in mind, it is not considered appropriate to make revisions to the growth forecasts for the first quarter since, when the new information is incorporated, the rough models point to an annual expansion of 4.8% (the same as what was given in the previous report where a 4.2% to 5.4% interval was shown with 4.8% being the most probable scenario).

28. Information for the second quarter of 2014 is scarce and only that for April is available. The data suggest a slowdown in the growth of economic activity. This

would be, in part, the result of the reversal of the statistical effect associated with the number of working days in the first quarter.

29. In April, the consumer confidence index (CCI) published by Fedesarrollo which maintains a high correlation with the expansion of private consumption, remained at levels that are similar to those in March. Its current level is somewhat above its average calculated since 2001. This suggests that household consumption could continue a growth that is close to the average for this same period (4.0%).

30. The vehicle sales figures for April, published by Econometria, show an annual decline of 3.0%. This result is influenced by a very high base of comparison from the same month in 2013. In spite of the preceding, the trend of this series is still growing and suggests positive future strength.

31. Furthermore, consumer loans and the real interest rates will continue to favor the dynamics of private expenditure. The former stopped slowing down as it rose 11.54% in April (compared to 11.3% in March and 11.6% for the first quarter) and the real rates continued to show a slight downward trend due to the rise in inflation.

32. With respect to supply, the indicators available showed mixed performance. According to the Fedesarrollo survey with information as of April, although the indicators of orders, expectations, and confidence improved for industry, the indicator for inventory deteriorated. The trend for the series, which showed favorable strength, maintained steady growth. This confirms the gradual recovery of manufacturing in Colombia.

33. The merchants consulted by Fedesarrollo, in turn, (seasonally adjusted series) continued reporting improvements in both the current and future outlook for their sales in April. Something similar can be seen in the Fenalco survey.

34. In contrast with the above, the total demand for electricity slowed down significantly as it went from growing 5.7% annually in March to 1.2% in April. Nevertheless, the trend component continued expanding and is maintaining its positive slope.

35. The level of petroleum production fell again. It went from 977 mbd in March to 935 mbd in April on average. Based on this record, the annual contraction was 7.1%, which can be explained by the attacks on the infrastructure (as is the case of

the Caño Limon-Coveñas oil pipeline). Coffee production was 832,000 60 kg. bags in April resulting in an annual fall of 14.2%. The high base of comparison with respect to the previous year is the explanation for this atypical decline.

36. With all of the above, the growth predicted for all of 2014 remained between 3.3% and 5.3% with the most probable figure being 4.3%.

III. Behavior of Inflation

37. In April 2014, the annual consumer price inflation rose again for the fourth consecutive month. The figure reported by DANE was 2.72%, 21 basis points (bp) higher than what was recorded in March (**Table 1**). The monthly change was 0.46%, which was higher than the figure predicted by the Economic Studies Division and the one expected by the market. The CPI has accumulated an increase of 1.98% so far this year, which is higher than the one for the same period in 2013 (1.21%).

38. As was the case for the last quarter, the upward pressure was concentrated on the prices for food and regulated items at this time. Likewise, there were increases in the basket of tradables again although they were lower with respect to those registered for the other two groups mentioned above (**Table 1**).

Table 1

Behavior of inflation as of April 2014

Description	sep-13	dic-13	ene-14	feb-14	mar-14	abr-14
Total	2.27	1.94	2.13	2.32	2.51	2.72
Excluding Food	2.36	2.36	2.49	2.53	2.62	2.85
Tradables	1.34	1.40	1.57	1.61	1.65	1.83
Non- Tradables	3.70	3.76	3.61	3.61	3.55	3.51
Regulated Items	1.24	1.05	1.66	1.76	2.21	3.05
Food	2.05	0.86	1.20	1.78	2.23	2.39
Perishables	5.94	-0.16	2.13	2.61	3.17	6.89
Processed	0.18	-0.24	-0.18	0.40	0.92	0.51
Meals away from home	3.74	3.26	3.29	3.88	4.13	3.73

Core Inflation Indicators						
Excluding food	2.36	2.36	2.49	2.53	2.62	2.85
Nucleus 20	2.79	2.72	2.69	2.79	2.86	2.80
CPI excluding perishables, gas, public services	2.19	2.19	2.27	2.43	2.53	2.54
Inflation excluding food and regulated items	2.69	2.74	2.74	2.76	2.74	2.80
Average of first 4 indicators.	2.51	2.51	2.55	2.63	2.69	2.75

39. As was expected, core inflation maintained an upward trend in April for the fourth consecutive month. The average of the indicators monitored by the Economic Studies Division stood at 2.75%, 6 bp above the figure for the previous month and 24 bp higher than what was registered at the end of last year. Three of the four indicators rose at this time. The only indicator that did not rise was the CPI nucleus 20, which recorded a change of 2.8%, 6 bp below the figure for the previous month (**Table 1**).

40. The increase in the CPI excluding food was driven by the subset of regulated items. Their annual change went to 3.05%, 84 bp higher than the rate for the previous month. A rise in the price of natural gas was registered again in April and this largely explains the increase in that indicator. As mentioned in the previous report, the rate adjustments for natural gas are due to both changes in the regulatory formula that were applied earlier this year and the accumulated depreciation of the peso in recent months. There was also a significant surge in the annual variation of the CPI for electricity. In this case, it was due to both a low base of comparison (in April 2013 the rates increased slightly) and a rise in prices.

41. Likewise, within the CPI excluding food there was an upswing in the annual change for the group of tradables excluding food and regulated items that was stronger than the one registered the previous month. The upward trend for this basket is still related to the accumulated depreciation of the exchange rate. Over the last month, the upward pressures in this segment of the basket came from some increases in the prices of automobiles, airfare, clothing, and household utensils.

42. Meanwhile, the annual change in the CPI for non-tradables excluding food and regulated items maintained the slight downward trend that has been seen over the last four months. The figure for April was 3.51%, which is 4 bp lower than the figure for March (**Table 1**). The annual change in rent (3.48%) dropped for the second consecutive month after the upswings registered in the first two months of the year. Unanticipated drops in the areas related to entertainment, culture and recreation as well as in mechanical and medical services were also registered. The

performance of the group of non-tradables is still suggesting that the demand pressures would not be significant.

43. Regarding the CPI for food, an upsurge in the annual change was again registered. The figure for April was 2.39%, 19 bp higher than the figure for the previous month. This rise was led by the sub-basket of perishable products (6.9% annually compared to 3.2% the previous month). The prices of perishable products could be stabilizing after the low levels registered at the end of last year. The prices for potatoes and other tubers have recorded the largest increases. Thus, they are following the regular agricultural cycle in Colombia. In addition, processed foods and meals away from home showed declines for the first time this year. However, they remain at levels close to the average for the annual changes registered so far this year.

44. In this context, inflation expectations continued growing. Based on the monthly survey of financial market analysts done by Banco de la Republica in May, the average inflation expected for December of this year was 3.18% compared to 3.04% last month. Something similar took place in the case of the expectations for twelve months from now, which went from 3.13% to 3.16%. With respect to the expectations derived from the TES yield curve based on information as of May 21, there was a rise (20 bp on average) for the 2, 3 and 5-year horizons.

45. Non-labor costs continued to climb rapidly in April. The annual change in the PPI rose for the sixth consecutive month and came to 3.4% from 2.6% the previous month. The local component rose 130 bp, which could be due to the increase in prices of perishable goods and coffee. In contrast, the PPI for imported goods showed a drop of 166 bp, which may be attributed to the recent trends in the exchange rate.

46. Labor costs, in turn, continued adjusting to annual rates of around 4.0%. This should not undermine meeting the goal, especially when taking into account the usual productivity gains derived from labor and the reduction in the mandatory contributions this year.