PUBLIC VERSION

Working Papers from the Board of Directors Banco de la República

Monetary Policy Report

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Board of Directors

Banco de la República

Monetary Policy Report

Economic Studies Division

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I. External Context and Balance of Payments

1. Growth forecasts for the country's main trading partners did not change versus those presented in the previous report. However, there is an increase in global uncertainty that could be transmitted to these projections.

2. The data available suggest that growth of the country's trading partners would have remained very modest, according to the forecast in the previous Inflation Report.

3. In the United States, GDP growth in the third quarter was 2.9% annualized quarter (a.q.), accelerating versus previous quarters and better than expected by analysts (2.5% a.q.). Growth was explained by consumption, the variation in inventories, and net exports. As to the latter, this result surprised market agents positively. Residential investment continued subtracting from GDP, but to a lesser extent than in the previous quarter.

4. Total inflation increased in October, standing at 1.6%. This increase was mainly associated with the increase in the prices of the energy. Core inflation is close to the Fed's target (2.0%).

5. In this context, the Open Market Committee of the Federal Reserve (FOMC) at its November meeting decided to leave the benchmark interest rates unaltered within a 0.25% to 0.5% range. The implicit probabilities in the short-term bonds futures suggest that the FOMC will increase the benchmark rate by 25 basis points (bp) in December, and that another increase will probably take place in the second half of 2017.

6. As for the euro zone, GDP growth in the third quarter was 0.3%, very similar to the second quarter and to the projections of the technical staff of the Central Bank. The index for PMIs to October showed important upturns. Despite the lower level of retail sales to September, consumer confidence to November remains at relatively high levels. In October, total yearly inflation increased to 0.5%, while core inflation remained at 0.8%. In this context, the stance of the European Central Bank (ECB) remained unaltered.

7. The PMIs in China exhibited a significant increase in October, moving the manufacturing sector away from contraction. The economy continues

with the adjustment process towards a model more supported by consumption. Although growth data are close to the Chinese government's target, there are concerns regarding a sharp deceleration and probable financial instability caused by over-indebtedness of the economy.

8. In Latin America, the available data suggest that growth continues to be mediocre. Mexico's GDP growth in the third quarter (1.95%) was lower than the one observed in the previous two quarters, while that of Chile (1.6%) was a little higher than in the previous quarter. Both figures were in line with the forecasts presented in the October report.

9. The figures of economic activity for Perú suggest that output in the third quarter will expand at a higher pace than in the second. Additionally, negative growth rates are expected in Brazil, Ecuador, Venezuela, and Argentina.

10. Headline inflation in Chile and Mexico is within the target ranges; however, this is not so in Perú, where recent increases pushed inflation out of its target. In Brazil, inflation relented in October, but remains away from the target range.

11. In the meantime, the exchange rates in the region have depreciated as a result of the fall in oil prices, the electoral results in the United States, and the proximity of the increase in the benchmark interest rate by the Fed. The greatest variations took place in Mexico, Brazil, and Colombia.

12. In October, the country's terms of trade rose thanks to the increase in the price of its main export products. In November, the price of oil exhibited setbacks, while those for coal and nickel showed increases. Thus, no significant increases in the terms of trade are expected in November.

13. The recent fluctuations in the price of oil are associated with the likelihood that the OPEC reaches an agreement on reducing oil supply in its meeting of 30 November. The technical staff’s forecasts assume an agreement with partial compliance by this Organization. It is worth mentioning that the inventories have fallen compared with the high levels observed at the beginning of the year, and that production cuts are still in force in Libya and Nigeria.

14. In the first week of November, volatility of the financial markets was altered by the presidential elections in the United States. In recent weeks, the volatility indexes returned to low levels, exception for the one associated with oil, which remains high. Risk premia for Latin America rose, especially for Brazil, Mexico, and Colombia.

15. The rates of sovereign bonds of developed economies exhibited increases so far in November. There have been 50 bp increases in the rates of 10-year bonds in the United States.

a. Exports

16. In September, the value of exports in US dollars registered a yearly 4.9% fall due to decreases in all groups, particularly agricultural goods (-12.8%) and the group of other exports (-7.4%). To date, exports have fallen 20.4% mainly as a result of the fall in the sales of mining goods (-27.9%) (Table 1).

Table 1 Behavior of Exports in US dollars

September 2016			
	Annual Variation	Main contributing items:	
		Item	Annual variation of the item
Total	-4.9%		
Agricultural goods	-12.8%	Coffee	-22.6%
Mining goods	-1.3%	Oil Ferro-nickel	-26.6% -22.5%
Other exports*	-7.4%	Chemical Products Foods, Beverages and Tobacco, excluding Coffee	-13.5% -26.0%
Accumulated value for January-September 2016			
Total	-20.4%		
Agricultural goods	-7.8%	Coffee	-18.6%
Mining goods	-27.9%	Oil Coal	-44.3% -8.3%
Other exports*	-11.0%	Chemical Products Graphic and Editorial Arts (paper, cardboard, and their products)	-13.8% -29.1%

* In this area, the majority of the groupings of destinations fell, highlighting the 3.7% reductions towards the US and 37.9% towards the European Union.
Source: DANE

17. So far this year, the price index for total exports registered a significant drop (-18.5%), while the volume index has fallen moderately (-2.8%). This suggests that the value of exports continues contracting, mainly as a result of the reduction in prices, especially those of mining products (-23.4% yearly in the accumulated value to September).

18. According to the preview for foreign trade by DIAN, exports excluding oil and its derivatives increased 6.2% on a yearly basis in October. (According to this source, they would have fallen 6.4% in September; however, the decline reported later by DANE was 1.7%).

b. Imports

19. In September, CIF imports in US dollars recorded an annual 12.1% fall due to setbacks in external purchases in all groups, with those in capital goods (-16.9%) and raw materials (-12.8%) as the most important. So far this year, imports have fallen 19.6% (Table 2).

Table 2 Behavior of Imports in US dollars

September 2016			
	Annual Variation	Main contributing items:	
		Item	Annual variation of the item
Total	-12.1%		
Capital Goods	-16.9%	Industrial Machinery	-36.1%
		Construction Materials	-24.8%
Raw materials	-12.8%	Fuels	-53.8%
		Chemical and Pharmaceutical Products	-5.4%
Consumer Goods	-4.0%	Private Vehicles	-23.1%
		Clothing and other Textiles	-18.8%
Accumulated Value for January-September 2016			
Total	-19.6%		
Capital Goods	-29.4%	Transport Equipment	-59.3%
		Industrial Machinery	-29.1%
Raw materials	-14.7%	Fuels	-28.1%
		Chemical and Pharmaceutical Products	-12.2%
		Mining Products (for industry)	-18.1%
Consumer Goods	-14.4%	Private Vehicles	-26.3%
		Pharmaceutical Products and Toiletries	-9.4%

Source: DANE

20. So far this year, imports have fallen both in prices and quantities. To September, the price index fell 13.3%, while quantities declined 7.3%.

21. According to the preview for foreign trade by DIAN, CIF imports recorded an annual 18.9% fall in October. (According to this source, they would have fallen 15.7% in September; however, the decline reported later by DIAN was 12.1%).

II. Growth, Domestic Demand and Credit

22. Growth forecasts presented in the previous report are maintained in this one: for the third quarter of 2016, a figure between 1.0% and 2.2% with 1.6% as the most likely figure, and for the whole year between 1.5% and 2.5% with 2.0% as the central forecast. However, several of the indicators described below have yielded mediocre results and below expectations. Consequently, the likelihood that output for the whole year be below the central forecast has increased.

23. According to figures from the monthly retail survey (EMCM) published by DANE, in September, retail sales contracted 1.3% annually. With this, the third quarter registered a 2.0% fall, which implies deterioration compared to the 1.3% growth observed a quarter ago. The trend component of the series has weakened.

24. Excluding vehicle sales, the remaining items exhibited a 0.6% fall in September and a slight 0.1% growth in the third quarter. Thus, the indicator registered a slowdown compared to the figure from the second quarter of 2016 (+2.0%).

25. According to the same source, vehicle and motorcycle sales fell 4.9% on a yearly basis in September. The reduction was lower for the accumulated value of the third quarter (about -12.3%). This represents a further deterioration to the bad behavior that this line of retail trade has exhibited so far this year.

26. Other indicators that have a high historical correlation with the increase in household consumption also suggest a lower dynamism. Specifically, in September, the balance of sales of the Monthly Survey of Economic Expectations (EMEE) by *Banco de la República* maintained a slightly lower level than the one observed in the previous quarter.

27. Regarding gross fixed capital formation, excluding construction of buildings and civil works, the balance of investment expectations of the

EMEE in September suggests that this aggregate continues contracting in the third quarter.

28. On the supply side, the available indicators also suggest a lower performance during the third quarter compared to that observed in the first half of the year.

29. Total industrial production in September grew 4.0%, a figure lower than the one expected by the technical staff. Excluding oil refining, the remaining industries fell at a 0.9% rate on a yearly basis. Year to date, total industry expanded at a yearly 4.3% rate, and 1.0% excluding refining. In quarterly terms, the aggregate value exhibited a 2.3% expansion, which is a significant slowdown compared to the second quarter (6.2%). It is worth mentioning that this is explained by the negative impact of the trucking strike on industrial production in July, when the industry fell 6.3%.

30. Regarding construction, cement production in September fell 9.1%, with which the quarter also registered a similar annual contraction (9.1%). This was also observed for shipping, which fell 11.0% in September and 11.2% in the third quarter. On the other hand, construction licenses decreased 23.9% and 19.1% in September and the third quarter, respectively.

31. According to the figures for the third quarter by the National Mining Agency, coal production increased 17% compared to the same period in 2015, moving from 19.9 to 23.4 million tonnes.

32. The figures for the fourth quarter of 2016 are scarce and do not allow to determine a reliable forecast of GDP growth. However, some indicators suggest a somewhat weaker behavior of household consumption, more than would have been registered between July and September.

33. In October, the Consumer Confidence Index fell slightly compared to the previous month. However, the level this month stood above the average for the third quarter. It is worth noting that the level is significantly below the average calculated since 2001.

34. On the other hand, with information to October, the number of license plates issued by the *Comité Automotor Colombiano* (Colombian

Automotive Committee)[1] exhibited a 35.2% decrease. Although the effect of the 15th Automobile Exhibition in Bogotá on vehicle sales in November is uncertain, the data from October and the trend for the year also suggest a weak performance of durable goods for household consumption in the last quarter of the year.

35. As for the financial market, the dynamics of indebtedness continues to moderate from high levels relative to output. Commercial debt continued to decelerate (5.7%), and the rate of increase for households stabilized at 13.1%.

36. Supply indicators also point at a further weakening of the economy for the fourth quarter. The figures of the *Federación Nacional de Cafeteros* (National Federation of Coffee Growers) recorded a coffee production of over one million 60kg-bags (1,395,000) in October, with a yearly 2.0% increase. So far this year, the accumulated growth is around -1.2%, with a production close to 11,260,000 bags.

37. In October, total energy demand contracted 3.0% on a yearly basis, and its trend component flattened. Breaking down the energy demand, regulated and unregulated demand fell 1.8% and 4.4%, respectively.

38. In October, oil production was 846 thousand barrels per day, on average, which implies a yearly contraction of 15.3%. So far this year, the average production stood at 894 mdb, which represents a yearly 11.2% fall.

39. Regarding the labor market, with figures to September, the unemployment rate (UR) continues to show an upward trend, particularly in urban areas. Yearly increases of the UR have been observed in most cities. This is due to a decline in the occupation rate. Although employment has stopped expanding, a positive annual growth rate for salaried and formal employment is still observed.

40. In general terms, nominal wage adjustments would have remained stable with some marginal slowdowns.

[1] Integrated by *Asociación Nacional de Industriales* (ANDI), *Federación Nacional de Comerciantes* (FENALCO), and the firm *Econometría*.

III. Behavior of Inflation and Prices

41. Annual inflation maintained a downward path in October, standing at 6.48%. This completes three consecutive months of decline since July, when it reached a maximum of 8.97% (**Table 3**). Accumulated inflation so far this year amounted to 5.19%, a figure lower than a year ago (5.47%). Monthly variation was once again slightly negative, (-0.06%), lower than expected both by the market (0.11%) and the technical staff at *Banco de la República*.

Table 3

Headline and Core Inflation - to October 2016

Description	Weight	Dec 2015	Mar 2016	Jun 2016	Jul 2016	Aug 2016	Sept 2016	Oct 2016	Participation percentage in monthly acceleration	Participation percentage in acceleration of the year to-date
Headline inflation	**100.00**	**6.77**	**7.98**	**8.60**	**8.97**	**8.10**	**7.27**	**6.48**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.17**	**6.20**	**6.31**	**6.26**	**6.10**	**5.92**	**5.64**	**26.23**	**(103.48)**
Tradables	26.00	7.09	7.38	7.90	7.87	7.53	7.20	6.49	**21.22**	47.85
Non-tradables	30.52	4.21	4.83	4.97	5.01	5.05	4.85	4.81	**2.33**	(58.41)
Regulated items	15.26	4.28	7.24	6.71	6.40	6.10	6.19	6.07	**2.67**	(92.92)
Food inflation	**28.21**	**10.85**	**12.35**	**14.28**	**15.71**	**13.06**	**10.61**	**8.53**	**73.77**	**203.48**
Perishables	3.88	26.03	27.09	34.94	39.27	21.27	6.66	(2.18)	51.27	407.19
Processed food	16.26	9.62	10.83	12.09	13.33	13.07	12.56	11.75	16.41	(122.92)
Eating out	8.07	5.95	7.53	8.11	8.50	9.00	9.18	8.64	6.09	(80.79)
Core inflation indicators										
Non-food inflation		5.17	6.20	6.31	6.26	6.10	5.92	5.64		
Core 20		5.22	6.48	6.82	7.03	7.07	6.73	6.58		
CPI excluding perishable foods, fuel and utilities		5.93	6.57	6.77	6.92	6.97	6.65	6.37		
CPI excluding food and regulated items		5.42	5.91	6.20	6.22	6.10	5.84	5.52		
Average of core inflation indicators		**5.43**	**6.29**	**6.52**	**6.61**	**6.56**	**6.29**	**6.03**		

Source: DANE. Calculations by *Banco de la República*.

42. As has been happening since August, the decrease in annual headline inflation in October was mainly explained by the decline or slight adjustment of food prices, particularly perishable items. Added to this is the fall in the annual CPI variation excluding food, led by the subgroup of tradables (excluding food and regulated items). The other main components of the CPI (non-tradables and regulated items) also contributed to the reduction of the annual inflation rate in the last month to a certain extent.

43. Core inflation, measured by the average of the four indicators monitored by the Central Bank, lowered from 6.29% in September to 6.03% in October. All the indicators considered fell (**Table 3**), with the CPI excluding food reaching the lower level (5.64%) and Core 20 the highest (6.58%).

44. Within the CPI excluding food, the tradable component lowered from 7.20% in September to 6.49% in October). This variable completes four months of successive declines, which suggests that the pass-through of

accumulated depreciation between mid 2014 and the first months of 2016 would be close to being completed. This does not imply that said channel cannot be reactivated should the depreciation observed in the last few weeks continue.

45. As for the CPI for non-tradables, its annual variation fell slightly, reaching 4.81%. This decrease adds up to those from the previous two months. The CPI for leases also contributed to this reduction (which moved from 4.1% in September to 4.0% in October). The other groups remained stable or exhibited slight increases. The annual variation of non-tradables (excluding food and regulated items) increased in 2015 and in early 2016, mainly driven by the prices of services, which would have been caused by the increase of salary cost pressures and to the greater indexation and inflation expectations. The reduction in the last few months, however, might suggest that these factors are relenting, but also that weakening of domestic demand is limiting the readjustment of prices.

46. The CPI for regulated goods registered a slight decrease, moving from 6.19% in September to 6.07% in October. This behavior was due to the decrease in the annual variation of the CPI for utilities, which went from 10.53% in September to 8.93% in October, mainly due to the reduction in the rates of household gas (whose annual variation fell from 14.0% to 10.3%). Contrastingly, the subgroups of transport and fuel increased (from 4.99% to 6.02% and from -2.98% to -2.06%, respectively). The former, due to the adjustments in taxi fares in Bogotá. The latter was due to a low base of statistical comparison in the same month last year, when a significant reduction in this price took place.

47. In October, a significant decline in the annual variation of the food CPI was observed again. The data for this month was 8.53% compared to 10.61% in September and 15.71% in July, the maximum level observed in recent years. As expected, with the disappearance of *El Niño* and the end of the trucking strike, the food supply and its prices have continued to return to normal levels. This has been the case especially for the CPI for perishable foods, whose annual variation once again declined significantly in October, standing at -2.2% compared to 6.7% a month ago and 39.27% in July. Prices of various vegetables and potato continued to fall.

48. Additionally, the CPI for processed foods also fell in the last month (from 12.6% in October to 11.7%) thanks to falls or limited price increases (compared with those observed in the same month of 2015), in products such as cereals, oils, beef, eggs, chicken, and rice, among others. The stability of the exchange rate between March and September and few pressures from international prices, together with a less dynamic domestic demand, would explain this behavior.

49. In October, annual CPI variation of meals outside the home began to lower (reaching 8.6% versus 9.2% a month ago), after several quarters of increases. A preliminary exploration suggests that there is a lag of about a quarter between the break in the prices of food and this indicator during *El Niño*.

50. Non-labor cost pressures continued to be moderate in October. Yearly PPI variation for domestic supply (domestically produced and consumed items plus imported goods) increased slightly from 3.38% in September to 3.48% in October. The increase in the PPI for imports (from -1.60% in September to 0.24% in October), reflects the depreciation of the exchange rate in the last weeks. Contrastingly, locally produced and consumed goods slowed down (from 5.70% to 4.95%).

51. As for labor costs, the behavior was mixed. Salary adjustments for retail fell from 6.16% in September to 5.42% in October, while those for industry increased from 5.93% to 6.98%. With information to October, the wages for heavy construction (5.2%) and housing (4.32%) showed no significant changes.

52. Inflation expectations to December 2016, obtained from the monthly survey to financial analysts collected at the beginning of November, fell, standing at 5.69% (vs. 5.98% from the previous survey). Inflation expectations to twelve months also lowered from 4.24% to 4.18%, while expectations to twenty-four months did so from 3.65% to 3.57%. Inflation expectations obtained from the October quarterly survey stood at 6.76% to December 2016, 5.60% to twelve months, and 5.07% to twenty-four months. On the other hand, inflation expectations embedded in TES in pesos and UVR (Breakeven Inflation), on average to 23 November[2], increased 45, 36 and 27 bp for 2, 3 and 5 year terms, respectively, relative to the average data from October. Thus, the average

[2] Versus the last meeting of the Board of Directors, BEI for 2, 3, and 5 years has presented variations of 7 bp, 12 bp, and 15 bp, respectively. On November 23 they posted at 4.22%, 4.10%, and 4.02%, respectively.

data for BEI so far in October for these terms stand at 4.15%, 4.01%, and 3.88%, respectively.