PUBLIC VERSION

Working Papers from the Board of Directors Banco de la República

Monetary Policy Report

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Economic Studies Division

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I. External Context and Balance of Payments

1. The international price of Brent oil showed a slight increase, moving from an average value of USD $48 per barrel in September to USD $49 per barrel to October 27, but posted below the expectations of the technical staff at *Banco de la República* published in the June edition of the Inflation Report (USD $59 per barrel). The low prices of oil are explained, to a large extent, by greater-than-expected weakness in global demand (mainly China's), the high levels of oil inventories, and the prospects that the oil supply would remain high.

2. The prices of nickel and other metals exported by some countries in the region have also increased in the last few weeks, although they continue exhibiting significant declines in yearly terms. The international price of coffee and some food items imported by Colombia exhibited slight increases, but remain at low levels. Thus, Colombia's terms of trade would have remained relatively stable at the levels observed in prior months, which continue to be the lowest since early 2009.

3. More recent records of economic activity suggest that global growth and that of Colombia's major trading partners for 2015 would be weaker than expected by the technical staff at *Banco de la República* in June’s Inflation Report.

4. In the United States, the first estimates of GDP for the third quarter show moderation of growth versus the figure observed three months ago, moving from a quarterly annualized rate of 3.9% to 1.5%. This slowdown was explained by a major reduction of inventories. Additionally, non-residential investment reduced its dynamism compared to that observed in the second quarter, while net external trade subtracted from the expansion of the GDP. In contrast, household consumption continued increasing favorably, consolidating as the main engine of growth for this economy. As for the US labor market, the figures to September exhibit moderation in employment creation, with which the unemployment rate remained stable at 5.1%. Regarding yearly variation in prices, total inflation reduced from 0.2% in August to 0.0% in September, mainly as a result of lower fuel prices. Core inflation indicators showed a slight increase in the same period, moving from 1.8% to 1.9%.

5. In this context, the press release for the October meeting of the Federal Open Market Committee (FOMC) of the FED suggests that the interest rate would be raised in December and would continue increasing gradually in the future. However, the strength of the US dollar and the complicated international

outlook continue to pose important risks to the normalization of the monetary policy in the United States.

6. In the euro zone, figures for real activity and industrial surveys for the third quarter indicate that the economy would have continued to expand at a modest rate. With regard to the yearly variation in prices, total inflation in September was negative again (-0.1%), while core inflation indicators remained stable at 0.9%. In this context, the European Central Bank (ECB) signaled that it may adopt new measures of monetary stimulus in December.

7. In China, GDP growth for the third quarter exhibited a slight moderation *vis-à-vis* the figure observed three months ago, moving from 7.0% to 6.9%. Indicators of industrial production, fixed-asset investment, and exports to September suggest a deepening of the slowdown in real activity. Additionally, yearly inflation in July remained low (1.6%). In this context, the Chinese Central Bank decided to reduce its benchmark rate by 25 basis points to 4.35%, and relaxed some regulatory requirements on bank deposits.

8. In Latin America, figures of real activity to August for Chile, Mexico and Peru indicate that these economies would have continued with a very low dynamism. Indicators available for Ecuador suggest a strong deceleration of growth during the third quarter. The records for Brazil suggest that a deepening of the contraction that began last year would be taking place. Finally, while there are no official figures for Venezuela so far this year, there are signs that its recession would have intensified.

9. Records of inflation for several countries in Latin America to September continued to show a growing trend. In Chile and Peru, while there were some reductions, annual variation of prices remains above the target range of their central banks. In Brazil, inflation remains high and with a marked upward trend. In contrast, in Mexico, inflation remained at the bottom of its central bank's target range.

10. As for international financial markets, a significant reduction was observed in the volatility indicators, following the high levels they had reached in mid-August. Similarly, the major stock market indexes recovered globally and in emerging economies. Besides, the rates of long-term bonds in the United States and in the major countries of the euro zone have exhibited some reductions.

11. In the case of Latin America, reduction in the risk premia of several countries of the region was observed, although they continue at high levels. Meanwhile,

the currencies reversed part of the sharp depreciation they had accumulated in prior months. Thus, the Colombian peso appreciated 4.9%, moving from an average value of COP $3,077 per dollar in September to COP $2,926 per dollar to October 27.

a. Exports and Imports

12. Total exports in dollars recorded a yearly fall of 41.6% in August, explained by a 53.2% decrease in the value of exported mining goods, and a reduction of 8.8% for other exports. The group of agricultural items exhibited a variation of 0.2%.

13. The fall in mining goods is mainly associated with lower exports of oil (-60.7%) and coal (-60.0%). The group of exports of agricultural goods recorded a fall in bananas (-15.7%), but an increase in exports of coffee (0.7%) and flowers (10.1%). Among other exports, decreases in machinery and equipment (-38.5%), food and beverages (-35.1%), and chemicals (-18.6%) stand out. By destinations, the following falls are highlighted: 54.3% to Venezuela, 17.5% to Ecuador and 13.0% to other destinations. In contrast, exports to the United States grew 20% annually during the month.

14. In the accumulated total of the year to August, total exports in US dollars fell 33.8%. This decrease is explained by the lower value of external sales of mining goods (-45.1%) and other products (-9.9%). Exports of agricultural goods grew 2.0% in that period. As for the former, this reduction was due to a large extent to the lower values of oil exported (-49,2%), refined products (-58.6%), and coal (-26.1%). Among the latter, the falls in foods and beverages (-16%), non-metallic minerals (-20.5%), and chemicals (-4.7%) stand out. Exports of agricultural goods grew thanks to the increase in coffee (13%).

15. In August, CIF imports in US dollars fell 9.5% on a yearly basis. This decline is associated with lower imports of capital goods (-11.6 %), intermediate goods (-2.5%) and consumer goods (-18.2%). In the case of capital goods, the fall is explained by the behavior of transport equipment (-15.5%), capital goods for industry (-10.7%) and construction materials (-8%). For intermediate goods, by the fall of foreign purchases of raw materials for industry (-9.8%), despite the fact that imports of other groups grew, such as fuels and lubricants (25.6%), and raw materials for agriculture (8.5%). Regarding consumer goods, it is due to the lower purchases of durable (-25.2%) and non-durable (-10.8%) goods.

16. So far this year to August, CIF imports in US dollars fell 11.8%. This is explained by decreases in intermediate goods (-15.6%), capital goods (-8.2%), and consumption goods (-9.3%). The fall in intermediate goods (-17.2%) is mainly associated with the 34% decline in fuels and lubricants, and of 9.6% in raw materials for industry. Within capital goods, the greatest contribution to the fall was that of those destined for industry (-10.5%) and construction materials (-10%). As for consumer goods, imports of durable goods exhibited a -15.1% variation, and those of non-durables -2.9%.

II. Growth, Domestic Demand, and Credit

a. External Growth Scenarios

Baseline or more likely scenario (Table 1)

17. Growth forecasts for the country's main trading partners were revised downwards in the present report, as compared to the ones published in the previous quarterly report. Thus, the forecast of the average yearly GDP growth of Colombia's major trading partners (weighted by non-traditional trade) moved from 0.9% to 0.7% for 2015 and 2.2% to 1.7% for 2016.

18. This revision was mainly due to the fact that Latin American economic performance by the end of 2015 and for 2016 would be weaker than expected in the June Inflation Report. In the case of Chile, Mexico and Peru, their recovery is expected to be slower, given that commodity prices would remain low and that demand on the part of its major trading partners would be modest. As for Brazil, the contraction of its economy would be deeper and would last until next year as a result of the fiscal adjustments that this country must implement, the loss of the investment degree, and the low confidence levels of investors and consumers. Finally, recession would have intensified in Venezuela.

19. In the case of the United States, the growth forecast for all of 2015 was revised slightly upwards due to a better-than-expected performance in the first semester. For the remainder of the year and for 2016, it is expected that the expansion of this economy is supported by a favorable dynamics of its domestic demand, especially consumption and non-residential investment. However, net external trade would be an obstacle greater than the one anticipated in the June *Inflation Report* as a result of a stronger weakening of demand by its trading partners and the strength of the US dollar.

20. Employment generation would continue favorably, although lower than what has been observed so far. In this way, current excess capacity would continue to be eliminated, and some upward pressure on wages would begin to appear gradually.

21. During the last months of 2015, inflationary pressures would be contained by the low prices of commodities, especially oil, and by the strength of the US dollar. In 2016, inflation would show a growing trend, mainly thanks to a low base of comparison, due to which it would slowly converge towards the Fed's long-term target (2.0%).

22. The FED would increase its benchmark rate in December, and would continue doing so very gradually throughout 2016. It is expected that this measure be transmitted in an orderly manner to the market rates.

23. In the euro area, recovery of the economy would continue taking place slowly, as expected in the previous Inflation Report. The measures taken by the ECB have entailed improvements in confidence and have restored the credit channel to some extent, which would in turn encourage private consumption and investment. However, it is expected that exports outside the European Union do not significantly boost growth in the region due to the weak global demand.

24. In this region, inflation would remain contained during the latter part of the year and in 2016 as a result of the low prices of fuels, scarce demand pressures, and modest inflation expectations. In this context, the ECB would adopt new measures for monetary stimulus and expand its quantitative easing program.

25. As for China, growth would continue moderating as the investment in fixed assets and the expansion of credit reduce from the high levels recorded in previous years. Additionally, exports would weaken growth as a result of the Chinese yuan remaining strong *vis-à-vis* most currencies in the world and weak global demand. However, stimulus measures by the government and the central bank would allow for the slowdown not to be so marked.

Risks to the Baseline Scenario

26. A monetary policy error in the United States bringing upon potential adverse effects on financial markets and global confidence.

27. A stronger slowdown in China as well as in the rest of emerging economies. A stronger drop growth in China's growth would mainly take place due to problems associated with its financial stability. In the case of Latin American economies, reduction of international commodity prices or the strong depreciation of their currencies could affect their economic activity more than expected.

Table 1

Economic Growth Forecasts for Colombia's main Trading Partners

Country or Region	2015			2016		
	Low	Baseline	High	Low	Baseline	High
USA	2.2	2.5	2,8	2,0	2.6	3.0
Euro Zone	1.0	1.4	1,8	0.8	1.4	1.8
China	6.6	6.8	7,0	6.0	6.4	6.8
Brazil	(3.5)	(3.0)	(2.5)	(1.5)	(0.5)	0.0
Ecuador	(0.3)	0.3	0.8	(1.0)	0.5	1.0
Venezuela	(10.0)	(8.0)	(6.0)	(6.0)	(3.0)	0.0
Peru	2.3	2.8	3.3	2.8	3.7	4.3
Mexico	2.0	2.3	2.6	2.5	3.0	3.5
Chile	1.9	2.3	2.5	2.0	3.4	4.0

b. Projection of the Balance of Payments

28. During the first semester of 2015, the current account deficit was 6.2% of GDP (USD $9,466 m), greater than the one observed in the first semester of the previous year (4.5%, USD $8,261 m). This increase, as a percentage of GDP, is explained in 0.4 percentage points (pp) by the largest deficit in US dollars and in 1.3 pp by the effect of the depreciation of the peso in the measurement of GDP in nominal US dollars.

29. The estimation of the current account deficit for 2015 is higher than the forecast produced three months ago and which, as a percentage of GDP, remains above the one registered in 2014. The largest deficit is associated with the effects of the fall in the price of oil on the trade balance in the third quarter of the year (which was not considered within the projections on the Inflation Report issued in June) and a lower demand by some trading partners.

30. Thus, in the most likely scenario, the current account deficit for 2015 would be around 6.2% of GDP (**Table 2**). This result reflects a reduction in the deficit to USD $18,435 m (from USD $19,580 m in 2014), offset by a valuation effect of GDP in US dollars of 1.6 pp, given the estimated depreciation for the year on average (35.7%).

Table 2

BALANCE OF PAYMENTS - (Millons of US$)	2014	2015 Baseline
CURRENT ACCOUNT (A+B+C+D)	(19,580.0)	(18,441.0)
Percentage of GDP	(5.2)	(6.2)
A. Goods	(4,610.0)	(11,628.0)
B. Non-factor Services	(6,659.0)	(4,583.0)
C. Factor Income	(12,670.0)	(7,529.0)
D. Current Transfers	4,357.6	5,300.0

31. So far in the third quarter, income from exports of goods has been affected once again by the behavior of the international prices of commodities. In this sense, the average prices of oil, coffee and ferronickel for the year are revised downwards, stressing the fall in traditional exports estimated a quarter ago. Similarly, the forecasts of exports for industrial products suggests a greater contraction of these sales versus the previous report, which responds to the impact of the lower demand for products on the part of Colombia's trading partners.

32. Expansions in the volumes of oil and coffee exported are foreseen, consistent with the growth projections for their production and, regarding coffee, greater than the one expected three months ago. On its part, the estimation of the exported volume of coal for 2015 has been revised downwards.

33. Compared to the results of the first semester and with the information available so far in the third quarter, it is expected that the adjustment of the current account deficit for the second semester is less than forecast in the June *Inflation Report*, mainly as a result of the greater fall in current income.

34. On its part, a significant reduction in imports is expected, particularly in the fourth quarter, due to less-dynamic domestic demand and the generalized fall of the international prices of imported goods, especially intermediate goods (fuels and derivatives), a behavior which has been observed with data from trade available to August.

35. Additionally, preliminary information published by DIAN for September suggests a major reduction of imports in yearly terms in that month (-25.5%), which confirms the trend observed during the year.

36. The decline in foreign purchases of goods will be accompanied by a lower deficit in the balance of services as a result of the positive effects of the exchange rate on this type of exports, and the decline of imports associated with freight services and tourism, and lower net outflows by income, reflecting the fall in profits for the mining-energy sector and the effects of depreciation and the economic slowdown on the rest of the sectors.

37. In terms of financing, it is expected that foreign direct investment flows in the second semester to the mining-energy sector continue at low levels compared to the observations for previous years, as a result of the outlook for prices of these goods. For the remaining sectors, direct investment of resources is expected to continue moderating due to the economic slowdown, except for some sectors which have exhibited dynamism in the first part of the year (manufacturing, retail trade, restaurants, hotels and construction). Additionally, net direct investment is estimated to be lower in the second semester given the announcements of major investments by Colombians abroad in this period.

38. On its part, portfolio investment flows will remain stable in the second semester *vis-à-vis* the observations from the first semester. This reflects a decrease compared to 2014, when the recomposition of JP Morgan's emerging public debt weights in favor of the Colombian titles took place. The foregoing will be partially offset by greater resources from other investments, particularly loans obtained by the non-financial public sector (**Table 3**).

39. Additionally, alternate scenarios for the central projection of the balance of payments for 2015 were considered based on different assumptions about the conditions of international financing and domestic growth. In a scenario in which these conditions remain positive, with growth of the economy of around 3.4%, the current account deficit would be 6.8% of GDP. Lower international financing along with a lower growth of the economy (around 2.4%) would result in a deficit of 5.7% of GDP.

Table 3

BALANCE OF PAYMENTS - (Millons of US$)	2014	2015 Baseline
CAPITAL AND FINANCIAL ACCOUNT (A+B+C+D+E)	**(19,640.0)**	**(17,994.0)**
A. Net Foreign Investment in Colombia	**(12,252.0)**	**(9,422.0)**
a. Foreign Investment in Colombia	16,151.0	12,963.0
b. Colombian Investment Abroad	3,899.0	3,542.0
B. Portfolio Investment	**(11,654.0)**	**(6,820.0)**
C. Derivative Instruments	**268.0**	**382.0**
D. Other investment (loans and other credits)	**(439.0)**	**(2,529.0)**
E. Reserve Assets	**4,437.0**	**395.0**
ERRORS AND OMISSIONS	(59.0)	447.0

40. For 2016, lower current-account deficit is foreseen, both in US dollars and in relation to GDP (around 5.8%). This would be mainly associated with a lower negative result of the trade balance, together with a better picture for the prices of some of the main export products, recovery in the trading partners, and the effect of the entrance into full operation of *Reficar* on fuel exports and imports.

II. External Context and Balance of Payments

41. The information available for the third quarter suggests that expansion of the economy would continue at levels similar to those recorded during the first semester. In this period, private consumption would have grown at a rate close to its average calculated from 2001, while public consumption would have exhibited a scarcely dynamic behavior. Regarding investment, there would have been mixed results: investment in machinery and equipment and transport equipment would have experienced new yearly setbacks, while construction of buildings and civil works would have grown at a faster pace than the rest of GDP items. Real exports would have contracted again, while imports would have also decreased (akin to the behavior of domestic imported demand), although to a lesser degree.

42. According to the most recent publication of the Monthly Survey of Retail Trade (EMCM) of the National Bureau of Statistics (DANE), in August retail sales expanded 6.2% *vis-à-vis* the same month in 2014 (5.4% for the two-month period of July-August), with an acceleration with respect to the records of the second quarter (2.7 % on a yearly basis).

43. Excluding vehicle sales, the increase in retail sales was 9.6% and 8.1% on a yearly basis for August and the two-month period, respectively (vs. 4.9% in the second quarter). The dynamics of sales in August took place in a context of discounts and promotions, particularly for the segment of durable and semi-durable goods.

44. Contrastingly, vehicle and motorcycle sales this month fell again *vis-à-vis* the same month last year (-9.2%). For the two-month period of July-August, the figure was -6.6% on a yearly basis, which represented an improvement versus the records of the second quarter (-7.7%). It should be noted that the trend component of this series suggests a recovery compared with the levels registered in previous months.

45. The figures for retail sales of new vehicles published by the Colombian Automotive Committee[1] also show a yearly decline of 16.3% in August. The number of licenses issued in September confirm this result. By disaggregating this last series between private and work vehicles, recovery is observed in the former, while the latter exhibits a deeper drop in the third quarter.

46. Other auxiliary indicators having a historically high correlation with the growth rate of private consumption produce mixed signals. On the one hand, the sales balance of the Monthly Survey of Economic expectations (EMEE) by *Banco de la República* suggests that the dynamics of household consumption would have been somewhat better than the one presented during the first two quarters of the year, thus confirming the trends revealed by DANE's retail trade survey.

47. In contrast, the Consumer Confidence Index (CCI) issued by *Fedesarrollo*, with figures to September, suggests that the slowdown in household consumption observed during the second quarter would have continued between July and September. The average of the index for the third quarter was significantly lower than those calculated for the first semester of the year and since 2001. By disaggregating its components, it is noted that both economic conditions and households expectations are at levels comparable with those in 2009.

48. The recent performance of labor market indicators does not allow foreseeing a change in household consumption trends. With figures to August, the unemployment rate remains at the low levels reached in previous months and does not suggest a change in that trend. Despite the stagnation of employment observed, the number of unemployed population has not increased due to the

[1] Participating entities: ANDI, *Fenalco* and *Econometría*.

fall in labor force participation. It should be noted that the lower dynamism occurs in both salaried and non-salaried workers.

49. Regarding gross capital formation, several indicators suggest that new reductions would have taken place in investment in machinery and equipment and transport equipment (although to a lesser degree than those observed during the second quarter):

- Imports of capital goods in dollars fell during July and August more than was observed in the second quarter. Despite the foregoing, international price indexes of such goods (in US dollars) reveal a recent downward trend, which indicates that the fall in real terms would not have been so marked.
- In August, the balance of medium-term investment expectations of the EMME of *Banco de la República* improved slightly *vis-à-vis* the levels of the second quarter. This suggests that gross fixed capital formation different from that of construction of buildings and civil works, would have exhibited a lower reduction than the one calculated between April and June.
- With figures to September, the trend component of the series of licenses for working vehicles continues suggesting a deterioration of the dynamics for this type of investment.

50. As for foreign trade, export figures in US dollars published by DANE to August suggest that this item of GDP would have fallen in real terms more than in the second quarter.

51. In the case of imports, the same source suggests that a decline in real terms would have also taken place, although lower in magnitude. This is due to the behavior of investment in machinery and equipment and transport equipment, as well as that of consumption of durable and semi-durable goods. It should be noted that the fall projected for this item would be influenced by a high base of comparison in the same quarter of 2014, and that, despite this, an increase compared to the level in the second quarter is expected. The foregoing would have also happened for investment in machinery and transport equipment and durable and semi-durable consumer goods.

52. On the supply side, available indicators suggest that industry GDP in the third quarter would grow on a yearly basis after the fall registered between April and June (-0.9%). In August, the industrial production index (IPI) increased 2.6% on a yearly basis, and 1.6% in the two-month period of July-August. Excluding oil refining, the remaining industry expanded in August at a 2.8% rate on a yearly basis.

53. According to a survey by *Fedesarrollo* with information to September, the indicator of stocks (which is countercyclical) declined *vis-à-vis* last month, and its trend component shows a favorable outcome for the performance of the sector. The current volume of orders increased versus August, and its trend component also suggests a gradual recovery of the sector. Production expectations to three months increased, but the volatility of this indicator has been very high in the last two years (the trend component continues to show deterioration). Finally, as a result of this, industrial confidence improved.

54. As for retail trade, with information from *Fedesarrollo* to September, the current economic situation of retailers and expectations to 6 months increased *vis-à-vis* the previous month. The trend component of current sales shows dynamism, while that of future sales expectations continues to fall.

55. As for agriculture, the National Coffee Federation reported that coffee production in September was 1,058,000 60-kilo bags, which implied a 16.0% growth on a yearly basis. However, the aggregate for the third quarter slowed down (14.7% versus 17.8% in the second). In August, cattle slaughter recovered, increasing 1.1% on a yearly basis after having fallen 1.2% during the second quarter.

56. Regarding mining, although oil production data for September (1,007 tdb) was higher than in the previous two months (on average 955 tdb), a 1.1% fall on a yearly basis was observed in the aggregate for the third quarter. This is explained by disturbances of public order that took place in July.

57. Regarding the construction sector, cement production grew 7.9% on a yearly basis in August, and 5.5% for the average of July and August (vs 4.3% in the previous quarter). On the contrary, although construction licenses increased 23.6% in August and 6.1% in the two-month period of July-August, the accumulated value for twelve months decreased 5.7%.

58. Lastly, the total energy demand increased 6.6% on a yearly basis in September. This led to a yearly acceleration of 3.3% in the second quarter to 4.8% in the third. The trend component also accelerated significantly. On this occasion, there is no information on non-regulated components, given that the source is revising the ISIC classifications.

III. Behavior of Inflation and Prices

59. Annual consumer inflation rose sharply in September, posting at 5.35%, i.e., 61 basis points (bp) above the data from the previous month (**Table 4**). Monthly variation was 0.72%, higher than expected both by the market (0.29%) and the technical staff at *Banco de la República*. Although all groupings of the CPI contributed to boost yearly inflation, the recent acceleration concentrated especially on tradable goods excluding food and regulated items, and on perishable foods.

60. Accumulated inflation so far this year was 4.76%, considerably surpassing the 3.08% register for the same period last year. The increase in annual inflation since December last year is explained in a 52.9% by the increase in the tradable component of the CPI excluding food and regulated goods. It was followed by the prices of food, whose contribution was 44.7% (especially processed foods) and the CPI for non-tradables excluding food and regulated goods, which contributed 16.6%. On the contrary, the CPI for regulated items contributed negatively (-14,2%) (**Table 4**).

Table 4

Inflation to September 2015

Description	Weight	Dec 2013	Dec 2014	Mar 2015	June 2015	July 2015	Aug 2015	Sept 2015
Total	**100.00**	**1.94**	**3.66**	**4.56**	**4.42**	**4.46**	**4.74**	**5.35**
Non-food Inflation	**71.79**	**2.36**	**3.26**	**3.46**	**3.72**	**3.98**	**4.20**	**4.58**
Tradables	26.00	1.40	2.03	3.46	4.17	4.69	5.23	5.90
Non-tradables	30.52	3.76	3.38	3.56	3.98	3.95	4.02	4.27
Regulated items	15.26	1.05	4.84	3.25	2.55	2.99	3.08	3.30
Food Inflation	**28.21**	**0.86**	**4.69**	**7.37**	**6.20**	**5.67**	**6.11**	**7.30**
Perishables	3.88	(0.16)	16.74	21.57	10.73	7.99	9.86	14.95
Processed food	16.26	(0.24)	2.54	5.99	6.00	5.71	6.06	6.71
Eating out	8.07	3.26	3.51	3.59	4.45	4.51	4.45	4.73
Core Inflation Indicators								
Non-food Inflation		2.36	3.26	3.46	3.72	3.98	4.20	4.58
Core 20		2.72	3.42	3.70	4.24	4.20	4.28	4.73
CPI excluding perishable foods, fuels and utilities		2.19	2.76	3.95	4.54	4.64	4.83	5.28
Inflation excluding foods and regulated items		2.74	2.81	3.52	4.06	4.26	4.53	4.95
Average of Core Inflation Indicators		**2.51**	**3.06**	**3.65**	**4.14**	**4.27**	**4.46**	**4.89**

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

61. In September, the average of the four core inflation indicators stood at 4.89%, thus completing a year of continuous increases. This has been the highest level since April 2009 (4.98%). In September, all indicators surpassed the target range for inflation. All of them increased versus August, with the CPI excluding

primary food, fuel and public utilities registering as the highest (5.28%). The CPI excluding food, with the lowest data, stood at 4.58% (**Table 4**).

62. Within the CPI excluding food and regulated items, the yearly variation of the tradable segment (5.9%) has increased steadily since August 2014, having stressed this trend last month (**Table 4**). Such behavior is closely linked to the depreciation of the peso. From July 2014 until September 2015, the exchange rate accumulated a 65.4% increase versus the US dollar, an adjustment that has passed through to the CPI for tradable items excluding food and regulated items, increasing 6.1% in the same period. It is important to highlight that the depreciation of the peso has been lower *vis-à-vis* currencies in other countries from which consumer goods are also imported.

63. In September, increases in the tradable component of the CPI excluding food and regulated items were once again generalized. Items such as vehicles, hair care, and washing machines recorded yearly variations exceeding 8.0%.

64. Regarding the CPI for non-tradables (excluding food and regulated items) their annual variation in September was 4.27%, somewhat higher than expected by the SGEE and 25 bp higher than the previous month (**Table 4**). The increase concentrated on rentals (whose weight in the group is 61%), which moved from 3.4% in August to 3.6% in September. Other upward pressures came from soccer tickets and items which, within non-tradables, are being affected by the exchange rate via costs. In general, a broad set of prices of this subgroup increased on this occasion. It should be noted that, although currently a slightly negative gap is estimated for the third quarter, this value was revised upwards *vis-à-vis* the quarterly report issued in June. Also, it is worth recalling that within the group of non-tradable goods there is an important set of highly-indexed services (education and health, among others), which in turn causes that significant increases in inflation from previous months be transferred to future inflation.

65. Annual variation in the group of regulated items moved from 3.08% in August to 3.30% in September (**Table 4**). This record is still lower than that of December 2014 thanks to the decrease in the price of gasoline at the beginning of the year. Last month's increase is linked to the adjustment of public utilities (whose annual variation rose from 5.6% in August to 5.9% in September), especially due to gas tariffs, which increased from 18.4% to 21.95%, (exhibiting a monthly variation of 2.6%). Currently, Colombia faces an excessive demand for gas as a consequence of *El Niño*. This fact is generating

an increase in the costs of power generation which will tend to increase tariffs for consumers.

66. As a consequence of the low levels of the reservoirs, gas shortage and greater thermal generation with liquid fuels (which is most expensive), on Tuesday, October 27, the government decided to increase electricity tariffs starting December by $7.00 pesos per kilowatt/hour, which would imply an increase of approximately $439 pesos for the lower socio-economic stratum (1) and $2,946 pesos for the highest (6). However, according to the Ministry of Mining and Energy, the increase in tariffs would not exceed 1.8%, on average. Similarly, a significant tariff increase for aqueduct utilities is expected in October and November, given that the adjustment rule began operating in September because a 3.0% variation of the CPI has already been accumulated.

67. In September, annual food inflation (7.3%) increased versus August (6.1%), surpassing the forecast of the technical staff of *Banco de la República*. By components, it was noted that processed items increased from 6.1% in August to 6.7% in September, while perishables rose from 9.9% to 15.0%. Prices of imported food have exhibited increases that would be related to the accumulated depreciation of the peso. Meals outside the household, after 4 months of relative stability around 4.5%, increased in September to 4.7%, incorporating recent increases in food prices, rent, and some public utilities.

68. In the past three months, pressures from non-labor costs have been increasing, according to the new increase in yearly variation of producer prices (PPI) for domestic supply (produced and consumed items plus imported goods) from 8.1% in August to 8.7% in September. On this occasion, the increase is associated with the local component of the PPI, whose annual growth in September (4.2 %) was higher than in August (3.6%). On its part, the upward trend of the PPI for the sub-group of imported items, which has been observed for several quarters, has moderated.

69. With information to August and September, wages continued exhibiting adjustments which were compatible with the inflation target range. Those for heavy construction (3.8%) and housing (4.2%) showed no significant changes during September. Those for retail trade exhibited an acceleration, moving from 3.5% in July to 4.0% in August, with growth rates lower than those of last December (6.8%).

70. Inflation expectations to December this year obtained from the monthly survey to financial analysts with information to the second week of October, increased

significantly between September (4.72%) and October (5.58%). Inflation expectations to twelve months, obtained from the same survey, also rose, moving from 3.60% in September to 4.12% in October. Those registered in the quarterly survey of expectations stood at 5.03% for December, *vis-à-vis* 4.13% a quarter before. On its part, on average so far this year to October 27 versus the average data from September, implied inflations (Break-even Inflation, BEI) embedded in Colombian sovereign bonds (TES) in pesos and UVR have increased for 2, 3 and 5 years (27 bp, 25 bp, 15 bp, respectively), while decreasing for a 10-year term (24 bp). Thus, Break-Even Inflation (BEI) to 2, 3, 5 and 10 years posted at 4.51%, 4.44%, 4.38%, and 4.39%, respectively.