BANCO DE LA REPÚBLICA
DIVISION OF ECONOMIC STUDIES

Description of the external circumstances facing the Colombian economy, the developments in foreign trade, the performance of domestic demand, output and lending, and the behavior of inflation and inflation expectations

I. The External Context, Exports and Imports

1. Indicators of productive activity in the United States during the third quarter showed that country's economy maintained the momentum exhibited in the previous quarter. The August figures for retail sales and industrial production reflect favorable growth. The business and consumer opinion indexes suggest this performance would continue during the remainder of the year.

2. As for prices, overall inflation and core inflation in the United States remain below the Federal Reserve's target of 2%.

3. The job market continued to recover during the month of August. The unemployment rate declined to 6.1%, while the number of vacancies is higher than it was before the crisis. However, the underemployment rate and long-term unemployment are still a ways from their historical averages.

4. In terms of monetary policy, the Federal Reserve announced its asset purchase program will come to an end in October, as planned. Moreover, interest rates would not be increased prior to the second half of 2015. However, according to the economic forecasts published quarterly by the Federal Reserve, the hike would be sharper than was estimated several periods ago.

5. Accordingly, the good economic results in the United States during the third quarter and the revisions made in the GDP data would place economic growth for the entire year above the forecast, which was 1.9%.

6. The August figures for the euro area show industrial production grew at a very modest pace. A breakdown by country reveals slight growth in Germany and Spain, coupled with a drop in Italy and a standstill in France. The surveys of industrialists suggest manufacturing would continue to weaken throughout the rest of the year.

7. As for private consumption, retail sales grew at a slower pace in July. This was generally the case in the major European countries.

Retail sales would continue to be sluggish in the coming months, given the sharp drop in household confidence.

8. Annual inflation in the euro area remained at 0.4% in August, continuing the risk of deflation in the region. In this context, the European Central Bank announced a further reduction in its benchmark rates, as well as the onset of a program to purchase asset-backed securities (ABS) as of October, which is intended to encourage the supply of credit in the euro area. The details of the program are still unknown.

9. All of this suggests the rate of growth in economic activity in the euro area during 2014 could be weaker than expected.

10. In the case of China, the annual changes in retail sales, industrial production and investment in fixed assets by August reveal a sharp slowdown, suggesting that economic growth during the third quarter would been more moderate than expected. The performance of the real estate market has not improved: the price indicators continue to signal declines. Given this information, some analysts have cut their forecasts for growth in 2014 to below the target set by the government (7.5%).

11. In Latin America, the annual change in indicators of economic activity during July point to a continuation of extremely weak third-quarter growth for Brazil, Peru and Chile. In the case of Venezuela, the contraction could be higher than expected (-1%), due to the structural problems facing that country’s economy.

12. The behavior of inflation in emerging economies has been mixed. In Chile and Brazil, it is still above target, while inflation in Peru and the Asian economies has slowed.

13. With respect to international prices for the commodities exported by Colombia, oil prices dropped significantly in recent months as a result of increased production in several Middle Eastern countries and lower prospects for global growth. In contrast, nickel and coffee prices are still high and above last year's levels.

14. Meanwhile, the prices of some imported foods are trending downward sharply, thanks to a larger supply brought on by good harvests in the United States and elsewhere.

15. The reduced prospects for growth in China and other emerging economies caused their stock market indexes to decline in September. In contrast, financial markets in the developed countries have shown no major changes in recent weeks.

16. As for Latin America's financial markets, an increase in risk premiums was observed, which could be related to the economic slowdown witnessed in some countries in the region during recent months. Simultaneously, the region's currencies weakened in the last few weeks.

17. With regard to Colombian foreign trade, total exports in dollars registered an annual increase of 8.5% in July, given added exports of the chief mining products (6.6%), leading agricultural commodities (25.5%) and "other" exports (9.2%). The highlights in the first group include increases in the value of shipments of oil (7.1%) and coal (20.6%), mainly as a result of larger volumes. In the second group, coffee stands out (44.9%), thanks to increased volume and higher international prices. The rise in flower exports (31.2%) was a high point as well. Industrial export growth (10%), especially in terms of food and beverages, chemicals, non-metallic minerals and vehicles, was the highlight in the third group.

18. The dollar value of exports fell 2.6% during the first seven months of the year, compared to the same period in 2013. This momentum is explained by the decline in exports of chief mining products (-2.9%) and "other" exports (-7.8%). The largest reductions in exports of mining origin were in petroleum by-products (-25.3%) and gold (-40.1%); in the case of "other" goods, they were in vehicles (-47%), other agricultural products (-41.4%) and other industrial goods (-15.4%). However, exports of the major agricultural products were up by 16.4% in annual terms, thanks to increases in coffee (21.6%), bananas (20.6%) and flowers (7.4%).

19. Total imports CIF rose 19% in July compared to the same month last year, given the growth in capital goods (29.7%), intermediate goods

(10.7%), and consumer goods (21%). In the first case, the increase was mainly in transport equipment (73.3%) and capital goods for industry (17.6%). In the case of intermediate goods, the largest amount of growth was in the category that includes fuels and lubricants (16.6%), followed by raw materials for industry (7.6%). In the case of consumer goods, the biggest surge was in durables (30%).

20. The total dollar value of imports CIF rose 8% during the course of the year to July, given added foreign purchases of intermediate goods (12.7%), consumer goods (7.2%) and capital goods (2.6%). Within the first group, the largest increases were in fuels and lubricants (30%), followed by raw materials for industry (7%). As for consumer goods, the durable goods category expanded appreciably (10.8%). The increases in capital goods were primarily in goods for industry (6%) and parts and accessories for transport equipment (21%).

21. It is important to point out that closure of the Cartagena refinery is mirrored in the decline in exports and the rise in imports. Therefore, one would expect a partial correction of the trade deficit, once the new refinery begins operating next year.

II. Domestic Demand, Growth and Lending

22. The Colombian economy grew at an annual rate of 4.3% in the second quarter of 2014. This figure represents a drop of 0.1% compared to the level in the first quarter and can be explained by fewer business days, supply shocks (the closure of Reficar), and a statistical base effect.

23. Although domestic demand slowed (from 9.0% to 7.7% in annual terms), it continued to exhibit important momentum and adds to economic growth in an important way. A breakdown by components shows the items that contributed the most to economic growth were investment in civil construction (17.8%) and government consumption (6.5%). In fact, both these items grew more than the economy as a whole. Importantly, the pace of growth in household

consumption continued (5.2%); this rate is similar to that of the previous quarter and exceeds the historical average (4.0%).

24. Net external demand contributed negatively to growth and more so than in the previous quarter. Although imports in real pesos slowed considerably (from 14.2% to 9.6% growth), exports dropped 8.6% (down from 2.4% growth in the first quarter).

25. As for the different branches of economic activity, the sectors registering the largest increases during the second quarter of 2014 were construction (10.2%), the financial sector (6.1%), and social, community and personal services (5.8%). Industry (-1.4%) and mining (-2.2%) posted annual declines. Although non-tradable GDP decelerated (from 7.3% to 6.0%), it still grew more than the economy as a whole, while tradables slowed sharply (from 5.3% to 1.7% growth). If mining is excluded, the growth in tradable GDP was 2.7%.

26. The indicators at hand for the third quarter of 2014 suggest the economy would continue to grow at levels similar to those observed in the previous quarter. The central forecast assumes the considerable momentum in government consumption and investment in civil works will continue.

27. According to figures from the DANE Monthly Retail Trade Sample (MRTS), the retail sales of business establishments rose 5.2% in annual terms during July (up from 3.5% in June and 6.6%, on average, from April to June). If the effect of sales of motor vehicles and motorcycles is excluded, the increase in retail sales during the same period comes to 4.9%.

28. The Monthly Survey of Economic Expectations (MSEE) conducted by Banco de la República indicates terms of sale and merchants' expectations for sales were favorable in July. The balance of the replies was above the average for the second quarter. Given the correlation between this indicator and household consumption, this GDP component is expected to perform well in the third quarter.

29. With respect to indicators of durable goods consumption , the MRTS showed vehicle sales rose 6.4% in July, in annual terms, after falling

4.0% the month before (they were up by 2.3% in the second quarter). On the other hand, the ANDI-Fenalco-Econometrics figures with data up to August show an annual increase of 17% in the number of automotive units sold. This constitutes acceleration compared to the increase during the second quarter (1.5%).

30. The consumer confidence index (CCI) published by FEDESARROLLO declined in August compared to the levels registered in previous months, although it did remain above its historical average since 2001. The drop in this indicator is due largely to changes in the index of medium and long-term consumer expectations (CEI), which fell sharply that month. There were no important changes in the index of economic conditions (IEC).

31. Additionally, the momentum in household consumer loan growth persisted in August (11.8% annually versus 11.7% in the second quarter). Likewise, real interest rates on loans to households (consumer and mortgage loans) during the same month remained at levels similar to those of the previous quarter.

32. The job market variables also provide a view of the good performance in private consumption during the third quarter. Unemployment rates for the country as a whole and for the thirteen main metropolitan areas continued to trend downward in July. Salaried employment, which has demonstrated a high correlation with private consumption, grew at a good rate in July (4.6%)

33. On the supply side, the few indicators that are available for the third quarter of 2014 suggest an improvement in construction, coffee production, energy demand and industry. As for commerce, in July and August, besides the momentum in retail sales mentioned already, the better current perception shown in the FEDESARROLLO survey is also an important feature. In contrast, the figures associated with oil production showed a decline in activity.

34. In the case of building construction, permits rose significantly in July (45.4%) and the 12-month accumulated rate continues to reflect an increase of around 13%. Cement production and shipments rose 11.4% and 8.1% in July, respectively.

35. As for industry, the industrial production index, without coffee processing, grew 1.6% year-on -year in July. The performance of the sectors remains mixed. Some saw significant growth (automotive vehicles (21.9%), milling and starch (8.6%), clothing (15.0%), other chemical products (5.1%), and other food products (7.7%)). In others, there were major contractions, as was the case with oil refining (-25.5%), special purpose machinery (-49.2%) and publishing and printing activities (-16.0%). It is important to point out that the poor performance of oil refining was due to temporary closure of the Cartagena refinery.

36. With information up to August, the leading indicators in the Fedesarrollo Business Opinion Survey (BOS), such as orders, inventories and industrial production expectations for the following three months, remained akin to the levels observed in July. This would suggest the gradual recovery witnessed in July could continue in August.

37. Coffee production in August totaled 1,151,000 bags; that is, 49.5% more than in the same month last year. As a result, the increase in July-August came to 34.7%, implying a large build-up from the second quarter (0.4%). Accumulated production so far this year comes to 7.9 million bags, with 17.6% annual growth.

38. During the same month, the total demand for energy rose at an annual rate of 4.3%, although it was down with respect to July. However, the trend is still favorable. The regulated component grew 5.6% and the unregulated component, 3.0%.

39. In contrast, oil production dipped below one million barrels per day in August (mbd 990). This implied an annual contraction of 4.0%.

40. In view of the foregoing, the growth forecast for the full year is still between 4.2% and 5.8%, with 5.0% being the most likely figure.

III. Behavior of Inflation

41. Annual consumer inflation rose in August and was 3.02%, which amounts to 13 basis points (bps) more than the outcome in the previous month (Table 1). This is the first time the indicator has been above the midpoint of the target range (3.0%) since October 2012. In terms of monthly variations, the August figure was 0.20%, as opposed to the average expectation of market analysts, which was 0.12%.

42. Core inflation also grew in August, as suggested by the average of the four indicators monitored by Banco de la República, which was 2.70% as opposed to 2.58% in July. The four indicators increased, with Core 20 returning to 3.0% and showing the highest level, and the CPI excluding perishables, fuels and public utilities, the lowest (3.4%) (Table 1). Non-food inflation came to 2.8%, up 11 basis points, while inflation excluding food and regulated items increased the least (by only 4 bp), ending at around 2.6%. The latter was due to the main pressures concentrated on food and regulated items.

43. As part of the non-food CPI, regulated items exerted upward pressure, as did non-tradables, although to a lesser degree. In the first case, the increases were concentrated in rates for residential electricity and natural gas, since the other components (fuel, public transport and water and sewage service) showed no significant changes. Consequently, the annual change in regulated items came to 3.8%, the highest in 24 months. Electricity rates began to register sizeable increases as of the second quarter. In August, the annual variation in the CPI for energy was 9.2%.

44. The annual increase to 3.3% in August for prices of non-tradables excluding food and regulated items (**Table 1**) is explained largely by a statistical effect associated with the sharp drop in prices for soccer tickets last year, a phenomenon that was not repeated in August of this year. Added to this was less of an increase in the tourism CPI. An important fact in this sub basket, which has occurred for several quarters, is the decline in the pace of adjustments in rental fees. Their annual variation came to 3.1% in August.

45. The annual change in prices for tradables, excluding food and regulated items, showed no variation and remained at 1.6% (**Table 1**). Prices for vehicles, mobile telephones, domestic appliances and

electronics continued to fall, likely experiencing, with some lag, part of the effects of peso appreciation in past months. However, other prices such as those for airfares, household cleaning supplies, personal hygiene products and periodicals, increased more than in previous months. If the new trend towards peso depreciation observed as of late July were to continue, it should generate further hikes in this sub basket during the remainder of the year.

Table 1

Behavior of Inflation up to August 2014

Description	Dec-13	Jan-14	Mar-14	Jun-14	Jul-14	Aug-14
Total	**1.94**	**2.13**	**2.51**	**2.79**	**2.89**	**3.02**
Non-food	**2.36**	**2.49**	**2.62**	**2.66**	**2.75**	**2.84**
Tradables	1.40	1.57	1.65	1.94	1.60	1.57
Non-tradables	3.76	3.61	3.55	3.45	3.17	3.29
Regulated items	1.05	1.66	2.21	2.14	3.60	3.83
Food	**0.86**	**1.20**	**2.23**	**3.11**	**3.26**	**3.47**
Perishables	-0.16	2.13	3.17	8.92	9.18	8.91
Processed	-0.24	-0.18	0.92	1.44	1.66	2.09
Meals outside the home	3.26	3.29	4.13	3.52	3.45	3.47
Core inflation indicators						
Non-food	2.36	2.49	2.62	2.66	2.75	2.84
Core 20	2.72	2.69	2.86	3.04	2.73	2.98
CPI excl. perishables, fuel & publ. utl .	2.19	2.27	2.53	2.53	2.33	2.42
Inflation excl.. food & regulated items	2.74	2.74	2.74	2.81	2.51	2.56
Average of the first four indicators	**2.51**	**2.55**	**2.69**	**2.76**	**2.58**	**2.70**

Source: DANE: Banco de la República calculations.

46. The annual change in food prices continued to accelerate, as was contemplated in previous reports. The August figure was 3.5%, which is the highest since October 2012. The majority of the pressure this time came from the basket of processed foods, mainly because of the increases registered for beef, milk, chicken and egg prices. In the case of meat, there have been price hikes of some consideration since May; these would be associated with fewer cattle being slaughtered (down 8.4% in the second quarter, according to DANE). On the other hand, according to the cattlemen's association, livestock would be entering a retention phase that can last for several quarters.

47. Imported foods (cereals and oils, mainly) and meals outside the home exerted no upward pressure, as has been the norm in recent

quarters. In the case of perishable food prices, there continued to be increases in vegetables and fruits, but they were offset by large reductions in potato prices. Thanks to the latter, perishables have ceased to contribute to the build-up in inflation, something that is likely to be reversed later this year or in early 2015, according to the production cycle for this product.

48. In this environment, expectations for inflation by the end of the year rose slightly, according to Banco de la República's monthly survey of financial market analysts. The survey at the beginning of September shows inflation is expected to be 3.4% by December 2014, as opposed to 3.3% a month ago. The changes in expectations at twelve months were minimal, and the figure was slightly above 3.1%. Expectations derived from the TES yield curve at two, three and five-year horizons showed no important changes and continued to fluctuate around 3.0%

49. The annual change in the PPI rose by 70 basis points in August to 2.96%. The hikes originated with prices for food produced and consumed in the country (meat, fruits and vegetables) and with all imported goods of agricultural origin. The latter is associated with depreciation of the peso; in this case, unlike what happens with consumer prices, the pass-through to domestic prices is quick. This being the case, some hikes in non-labor production costs are probably occurring; however, they are still moderate and should not jeopardize compliance with the inflation target for this year.

50. As for labor costs, salaries in industry and commerce by July, and those in construction by August reflect adjustments of about 4.0%. This is consistent with the inflation target. Moreover, the reductions during the current year in employer contributions to health care mean even less of an increase in labor costs from the standpoint of employers. Therefore, the pressures originating on this front have been limited and will continue as such during the rest of the year. The situation could change towards 2015, if the unemployment rate continues to drop.