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 main foreign news for Colombia was the Fed's decision in its meeting of September not to increase its benchmark rate, contrary to the expectations of *Banco de la República's* technical staff as presented in the June edition of the Inflation Report. According to the information provided, the decision was due to increased uncertainty in the international outlook and by lower-than-expected inflationary pressures. In spite of this, the projections of the members of the Fed's Federal Open Market Committee (FOMC) suggest increases in the benchmark interest rate for the last part of the year which would continue gradually in the future.

2. On the other hand, the international prices of some commodities to September 22 showed some increases compared to data from the previous month. Thus, the price of Brent oil rose 1.5%, on average, *vis-à-vis* the data in August. Despite this, the average price for September (US $48.24 per barrel) remains low as compared to previous years, so the terms of exchange for Colombia would remain at levels similar to those at the beginning of 2009.

3. The prices of copper and other metals recorded some increases versus the previous month. Between August and September, the international price of coffee fell and remained at relatively low levels.

4. The most recent records of global economic activity confirmed that growth for Colombia's major trading partners for 2015 would be lower than last year. The figures available so far in the third quarter suggest that the euro zone would have continued expanding at low rates, while China would continue slowing down. Meanwhile, Latin American economies grew at rates lower than those observed, on average, over the last few years. In contrast, real activity in the US exhibited some improvements, although they would not suffice to offset the low dynamism of the other trading partners of the country.

5. In the United States, figures to August for retail sales suggest that household spending would have continued to grow at a good pace, and that the housing market continued to exhibit some improvements. Meanwhile, industrial production continued to expand at moderate rates. As for the labor market, job creation continues at a favorable pace, with which the unemployment rate in August fell to 5.1%. Regarding the annual variation of prices, a slight increase in total inflation was noted (0.2%), while the core inflation indicator did not introduce changes, registering 1.8%.

6. In the euro zone, confidence indicators and industrial surveys for August indicate that the economy would have continued to expand at a modest rate. As for the variation of prices, annual indicators of total and core inflation remained relatively stable at low levels, registering 0.1% and 0.9%, respectively.

7. In China, indicators of industrial production, fixed-asset investment, and retail sales to August suggest that the slowdown in real activity continues. Additionally, annual inflation remained low (2.0%). In this context, the Chinese central bank has relaxed some of its regulatory requirements, seeking to avoid a sharp slowdown in credit and of liquidity available in the local financial system.

8. In Latin America, the economic activity records for Chile and Peru for July suggest some recovery as compared to the observations from the first part of the year, although still pointing at a low dynamism. The information for Brazil indicates that the contraction that began last year continues.

9. In terms of inflation, Latin American economies continued showing a mixed performance in July, although rising trends prevail. In Mexico, inflation reduced and ranked at the bottom of the target range for its central bank. In contrast, annual variation of prices in Chile and Peru increased, mainly as a consequence of the depreciation of their currencies. Annual variation of prices in Brazil remains high and with a marked upward trend.

10. Volatility indicators of international financial markets reduced from the high levels recorded at the end of August, although they still remain relatively high. For its part, the rates of long-term bonds in the United States and in the major countries of the euro zone have exhibited some reductions.

11. As for Latin America, with data to September 23, a slight increase in risk premia was noted in the majority of countries in the region, while their currencies continued depreciating *vis-à-vis* the US dollar. Thus, the risk premia in Colombia, measured with Credit Default Swaps to 5 years, increased 11 basis points (bp) on average so far in September, as compared with August, continuing at the highest levels since 2009. For its part, the Colombian peso registered a depreciation of 1.3% on average so far in September with respect to August, moving from COP 3,029.91 per dollar to COP 3,069.66 per dollar.

12. Regarding the country's external accounts, during the second quarter of 2015 a current account deficit of USD 4,319 m was recorded, slightly above that in the same period last year (USD 4,218 m). As a percentage of GDP, a significant expansion was observed (from 4.4% to 5.5%), given the effect of the sharp depreciation of the currency (30.5% on a yearly basis for the average of the second quarter) in the valuation of nominal GDP in US dollars. Compared to the results of the first quarter of 2015, the deficit decreased USD 829 m.

13. The external balance of the second quarter reflected a significant deterioration in the trade balance versus last year, as a result of the 31.2% contraction in the value of exports in US dollars on a yearly basis, compared to a 16.4% decrease in imports. This was offset by a lower deficit in the balance of non-factor services (due to a reduction in imports of transportation and business services) and lower net outflows in the factor income.

14. Deficit in the second quarter was financed by net capital inflows (without reserve assets) of USD 4,206 m (5.3% of GDP), which is USD 949 m lower than the one registered a year ago. This reflects a reduction of 21.1% on a yearly basis in the resources for net direct investment and lower capital inflows by net portfolio investment (-11.1% on a yearly basis). The resources for other investment (loans and other credits) also decreased during this period (17.4%) due to a lower net borrowing from both public and private sectors.

15. Compared to the projections presented in the last edition of the quarterly Inflation Report, the deficit was higher than expected and implies a slower-than-expected correction of the external imbalance.

a. Exports and imports

16. Total exports in dollars recorded an annual fall of 40.5% in July, explained by a general decline in the export value of main items. The decline in those of mining origin was 53.0%, while the item for other exports fell 15.2% and the main goods of agricultural origin fell 5.3%. The fall of the first item is mainly associated with the lower exports of oil (-56.9%), and coal (-42.8%). Regarding the main agricultural goods, flowers (-16.9%), and bananas (-16.7%) registered falls.

17. Within other exports, reductions in chemical products (-9.0%), vehicles (-54.5%), and textiles (-31.4%) stand out. By destinations, the 44.9% fall to Venezuela, 34.9% to Ecuador, and 1.4% to the United States are highlighted.

18. In the aggregate value of the year to July, total exports fell 32.6% due to a decline in external sales of mining goods (-43,9%) and other products (-8.5%). As for the former, the reduction was due to the lower values of oil exported (-47.5%), refined products (-58.5%), and coal (-25.3%). Among the latter, the falls in foods and beverages (-12.6%), non-metallic minerals (-19.5%), and chemicals (-2.4%) stand out. Exports of agricultural goods grew 2.2% thanks to the increase in coffee (15.0%).

19. In July, CIF imports in US dollars fell $18.3% on a yearly basis due to a widespread decline in the main groups. In the case of capital goods (-20.8%), the fall is explained by the behavior of transport equipment (-40.0%), capital goods for industry (-11.1%) and building materials (-10.7%). Falls in intermediate goods (-16.6%) were affected by the decline in raw materials for industry (-12.8%) and fuel and lubricants (-27.8%). As for consumer goods (-17.8%), the reduction was reported by lower purchases both of durable (-28.8%) and non-durable goods (-4.5%).

20. So far to July, CIF imports fell 12.1% compared to the same period in 2014, with declines in the main groups. The fall in intermediate goods (-17.2%) is mainly associated with the 38.2% decline in fuels and lubricants, and of 9.6% in raw materials for industry. Within capital goods (-7.8%), the greatest contribution to the fall was that of those for industry (-10.5%) and construction materials (-10.2%). Within imports of consumer goods (-7.9%), non-durables had a variation of -13.6% and non-durables of -1.6%.

II. Growth, Domestic Demand, and Credit

21. According to the latest information on GDP published by DANE, the Colombian economy grew at an annual rate of 3.0% during the second quarter of 2015. This figure, which stood slightly above the midpoint of the forecast range presented by the technical staff at *Banco de la República* in the previous Inflation Report (between 2.0% and 3.5% with most likely outcome at 2.7%), exceeded somewhat the record of the first three months of the year (2.8%). Growth between quarters was 0.6%, which in annualized terms corresponds to a 2.4% increase (*vis-à-vis* 3.3% a quarter before).

22. On the side of expenditure, a lower growth of domestic demand was registered once again as a result of a slowdown in consumption dynamics (greater for private consumption than for public) and an important adjustment of investment in machinery and transport equipment. Investment in construction expanded at a rate higher than the rest of the components of GDP (**Table 1**). Falls were observed in both exports and imports, with a positive net contribution of 0.2 pp to GDP growth.

Table 1

	2014				2014	2015	
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Whole year	1st Quarter	2nd Quarter (Obs)
Total consumption	**5.2%**	**4.4%**	**4.4%**	**4.9%**	**4.7%**	**3.5%**	**2.9%**
Household consumption	4.1%	3.8%	4.1%	5.3%	4.4%	4.0%	3.4%
Non-durable goods	3.6%	3.1%	3.9%	4.8%	3.8%	3.8%	3.6%
Semi-durable goods	3.8%	4.0%	3.4%	7.2%	4.6%	4.2%	1.9%
Durable goods	4.2%	5.1%	8.1%	12.8%	7.6%	3.0%	-0.4%
Services	4.8%	4.1%	4.1%	4.2%	4.3%	4.1%	4.1%
Final government consumption	9.4%	6.7%	5.3%	3.8%	6.2%	2.2%	1.8%
Gross capital formation	**14.6%**	**13.8%**	**10.2%**	**8.5%**	**11.7%**	**7.0%**	**1.5%**
Gross capital formation	13.3%	8.6%	11.8%	10.1%	10.9%	5.9%	1.9%
Farming, forestry, hunting and fishing	3.1%	3.0%	4.5%	7.9%	4.6%	-2.0%	-1.2%
Machinery and equipment	14.4%	7.8%	14.6%	12.2%	12.2%	1.5%	-5.0%
Transportation equipment	5.2%	11.1%	14.9%	16.6%	12.1%	30.3%	-8.9%
Construction and buildings	7.1%	1.2%	15.4%	7.4%	7.8%	2.2%	9.4%
Civil works	25.8%	13.7%	6.6%	3.7%	12.1%	6.7%	8.1%
Services	5.9%	1.7%	5.1%	1.3%	3.5%	1.8%	-0.6%
Domestic demand	**7.7%**	**6.1%**	**5.8%**	**5.8%**	**6.3%**	**4.2%**	**2.5%**
Total exports	**2.6%**	**-11.5%**	**4.1%**	**-0.5%**	**-1.7%**	**1.6%**	**-2.0%**
Total imports	**8.9%**	**5.2%**	**8.3%**	**14.2%**	**9.2%**	**8.6%**	**-1.8%**
GDP	**6.5%**	**4.2%**	**4.2%**	**3.4%**	**4.6%**	**2.8%**	**3.0%**

Source: DANE; calculations by *Banco de la República*

23. Compared to the forecast presented in the previous Inflation Report, the prognosis considered private consumer spending similar to the one observed, as well as less dynamic investment in non-tradable capital goods (construction) than was revealed by the figures by DANE. This was offset (although only partially) by weaker-than-expected public consumption, lower performance of investment in transportation equipment, and by real exports that reported declines.

24. The fall in real exports was due to the performance of the sales of oil, coal, metallic ores and refined products from oil. On the other hand, the majority of products under the category of non-traditional exports also recorded contractions, largely due to a replacement of the markets by our major trading partners and by lower external demand. In the case of imports, the main falls took place in other machinery and electrical equipment, transportation

equipment, and metallurgic products. In contrast, foreign purchases of grain mill products and starch, refined oil products, and chemicals increased.

25. By branch of activity, the sectors that grew more during the second quarter of 2015 were construction (8.7%) and mining (4.2%) (**Table 2**). The only branch that exhibited a decrease was industry (-1.3%). On the other hand, the tradable GDP reported a slight acceleration (from 0.3% to 0.9%), while the non-tradable GDP slowed down slightly (from 4.4% to 4.3%). It should be noted that in the case of the tradable GDP, its pace of growth is significantly lower *vis-à-vis* the average since 2000 (3.8%).

Table 2

Real GDP Yearly Growth per branches of economic activity

Branch	2014				2014	2015	
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Whole year	1st Quarter	2nd Quarter
Farming, forestry, hunting and fishing	6.2	0.3	1.9	0.8	2.3	1.7	2.5
Mining and quarrying	5.4	(2.3)	(1.0)	(2.7)	(0.2)	0.5	4.2
Manufacturing industry	4.6	(1.6)	(1.1)	(0.8)	0.2	(2.2)	(1.3)
Electricity, gas and water	4.6	3.8	4.0	2.9	3.8	2.3	1.6
Construction	14.1	8.7	10.9	6.1	9.9	4.7	8.7
Buildings	7.0	1.0	14.1	7.3	7.4	2.1	9.1
Civil works	24.4	14.8	6.6	4.2	12.0	6.7	8.4
Trade, repairs, restaurants and hotels	5.4	4.2	4.4	4.4	4.6	5.0	3.8
Transportation, warehousing and communication	4.8	4.4	4.2	3.2	4.2	2.9	0.5
Financial, real estate and corporate services	5.4	5.5	4.5	4.1	4.9	4.2	3.6
Social, community and personal services	7.7	5.5	4.9	3.8	5.5	3.0	2.5
Subtotal value added	6.5	3.9	4.0	3.1	4.4	2.7	2.9
Taxes minus subsidies	7.4	8.6	7.3	8.0	7.8	4.3	3.5
GDP	**6.5**	**4.2**	**4.2**	**3.4**	**4.6**	**2.8**	**3.0**

Source: DANE; calculations by *Banco de la República*

26. The information available for the third quarter is still scarce and does not allow to draw conclusions on changes in the trends of growth of the Colombian economy. The Central Bank's technical staff maintains the growth forecast at 2.8% for all of 2015, within a range between 1.8% and 3.4%.

27. According to the Monthly Survey of Retail Trade (EMCM) by DANE, total sales of retail trade without fuels expanded 4.6% on a yearly basis in July 2015. This figure represents a slowdown as compared to June (5.6%), although it is higher than that of the second quarter (2.6%). It should be noted that the results for June and July were influenced by a low base of comparison in the same months of 2014.

28. Excluding vehicle sales, retail sales grew at an annual rate of 6.6% in July, a number higher than the marks for June (5.4%) and the second quarter (4.8%).

Similarly, it should be noted that this result is a product of a low base of comparison last year.

29. Vehicle sales reported in the same survey fell 4.0% on a yearly basis in July. However, after adjusting for seasonality, the levels of the series registered above the records for previous months. Akin with the above, the figures of the Colombian Automotive Committee (CAC) to July recorded a 3.9% fall in total license plate registrations compared to the same month in 2014 (those for cars and SUVs grew 3.1% on a yearly basis, while those for working vehicles fell 11.0%).

30. Figures to July related to the behavior of employment indicate a relative stability of labor market conditions. The information available shows that the decline in the unemployment rate (UR) is explained particularly by a lower level of labor force participation, but not by an increase in employment. Additionally, salaried and formal employment has slowed down significantly in recent months.

31. According to the most recent publication, the Consumer Confidence Index (CCI) published by *Fedesarrollo* fell again in August compared to the records of July and the second quarter. On this occasion, the balance of the series was negative for the first time in six years. This fall is explained by a reversal of the economic conditions of the households. Also, the intentions for home, durable goods and vehicle purchasing are at historically low levels, only comparable to those of 2009. Additionally, the perception of price levels and unemployment increased.

32. As for credit, the consumption loan portfolio for households grew 13.6% on a yearly basis in August, maintaining the pace of expansion reached in the second quarter (13.61%). Interest rates remain at low levels and, in real terms, show marginal declines.

33. Regarding investment indicators, with information to July, the balance of investment expectations of the Monthly Survey of Economic Expectations (EMEE) suggests that the fall of gross fixed capital formation (other than construction of buildings and civil works) would continue in the second semester of the year.

34. On the supply side, the few indicators available for the third quarter of 2015 show mixed results. In July, in the case of trade, in addition to the

aforementioned dynamism of retail sales, the better current and future perception of traders gathered in the survey by *Fedesarrollo* stands out.

35. As for industry, according to the Monthly Survey of Manufacturing by DANE, the yearly growth of production in July was slightly positive (0.3%) and larger than anticipated by SGEE (-1.6%). It should be noted that the trend component of the series has an upward slope for the first time in the year. Also, it is worth mentioning that the increase for the year so far is still negative (moving from -2.0% in June to -1.3% in July). Excluding oil refining, industrial production fell 0.2% (so far this year it grew 0.2%). Regarding oil refining, a positive variation (3.5%) was noted for the first time in the year.

36. Other variables related to the sector obtained from the survey of business opinion by *Fedesarrollo* showed mixed signals. With information to August, while the indicator of orders and stock exhibits a slight improvement, the expectations to three months have deteriorated. For the same month, the demand for industrial energy showed a better performance (stepping from -2.0% in July to +1.8% in August). However, its pace of expansion is below its historical average since 1999 (4.8%).

37. On the other hand, total energy demand increased 5.0% on a yearly basis in August. The regulated component grew 7.4% and the non-regulated one by 0.4%. So far this year, expansions stand at 4.9% and 1.2%, respectively. The trend of the series shows a favorable performance.

38. In August, coffee production grew 9.8% on a yearly basis, although in the two-month period of July-August it slowed down *vis-à-vis* that of the second quarter (moving from 17.8% to 14.1%).

39. In contrast, other sectors have shown deterioration. In August, oil production averaged 966 thousand barrels per day, which implies a fall of 2.4% from the same month last year. A 2.4% reduction was also observed for the July-August period.

40. As for construction, licenses recorded a 11.4% fall on a yearly basis in July. Something similar happened with the twelve-month accumulated value, which presented a 9.4% decline. Cement production increased by 3.1% (4.3% in the second quarter). Finally, according to the statistics on concrete to July, although that destined to housing grew 6.0%, the one for civil works fell 3.1%.

III. Behavior of Inflation and Prices

41. In August, annual consumer inflation registered 4.74%, increasing for the second consecutive month, after the pause observed during May and June (**Table 3**). The monthly variation was 0.48%, a level higher than expected both by the market (0.18%) and the technical staff. This recent acceleration was centered on tradable goods excluding food and regulated items, and on food (perishable and processed).

42. The accumulated inflation so far this year was 4.02%, surpassing the register of 2.94% for the same period last year. The increase in annual inflation since December last year is explained in a 68.2% 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 of 38.7% (especially processed foods) and the CPI for non-tradables excluding food and regulated goods, which contributed 18.6%. On the contrary, the CPI for regulated items contributed negatively (-25.4%) (**Table 3**).

43. The average of the four core inflation indicators in August was 4.46%, thus completing eleven consecutive months of increases and reaching its highest level since June 2009. All the indicators rebounded in August, compared with July and surpassing the ceiling of the target range. CPI excluding food continued at the lowest level (4.20%), followed by core 20 (4.28%). CPI excluding primary food, fuels and public utilities rose to 4.83%, registering the highest level; CPI excluding food and regulated goods closed at 4.53% (**Table 3**).

Table 3

Inflation to August 2015

Description	Weight	Dec 2014	Mar 2015	Apr 2015	May 2015	June 2015	July 2015	Aug 2015
Total	**100.00**	**3.66**	**4.56**	**4.64**	**4.41**	**4.42**	**4.46**	**4.74**
Non-food Inflation	**71.79**	**3.26**	**3.46**	**3.44**	**3.72**	**3.72**	**3.98**	**4.20**
Tradables	26.00	2.03	3.46	3.64	3.74	4.17	4.69	5.23
Non-tradables	30.52	3.38	3.56	3.67	3.83	3.98	3.95	4.02
Regulated items	15.26	4.84	3.25	2.68	3.45	2.55	2.99	3.08
Food Inflation	**28.21**	**4.69**	**7.37**	**7.70**	**6.16**	**6.20**	**5.67**	**6.11**
Perishables	3.88	16.74	21.57	16.99	8.34	10.73	7.99	9.86
Processed food	16.26	2.54	5.99	7.00	6.55	6.00	5.71	6.06
Eating out	8.07	3.51	3.59	4.68	4.45	4.45	4.51	4.45
Core Inflation Indicators								
Non-food Inflation		3.26	3.46	3.44	3.72	3.72	3.98	4.20
Core 20		3.42	3.70	3.97	4.06	4.24	4.20	4.28
CPI excluding perishable foods, fuels and utilities		2.76	3.95	4.29	4.39	4.54	4.64	4.83
Inflation excluding foods and regulated items		2.81	3.52	3.65	3.79	4.06	4.26	4.53
Average of Core Inflation Indicators		**3.06**	**3.65**	**3.84**	**3.99**	**4.14**	**4.27**	**4.46**

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

44. Within the sub-basket of the CPI excluding food and regulated items, the annual variation of the tradable component (5.2%) has increased continuously since August last year. This trend was more pronounced last month, when a 54 bp increase was observed (**Table 3**). From July 2014 until August 2015, the exchange rate accumulated a 62.7% increase *vis-à-vis* the US dollar (the strongest depreciation since the beginning of the century), reflected in an adjustment, during the same period, of 5.3% in the CPI of tradable goods excluding food and regulated items. It is important to notice that the depreciation of the peso has been lower versus other countries' currencies from which consumer goods are also imported.

45. In August, widespread increases took place again in different items of the tradable component of the CPI excluding food and regulated items. Items such as vehicles, washing machines, hair care and airline tickets recorded annual adjustments that exceeded 10.0%.

46. For its part, annual variation of the CPI for non-tradables excluding food and regulated items stepped from 3.95% in July to 4.02% in August (also surpassing the record for last December, 3.38%) (**Table 3**). All subgroups increased their levels, thus: rentals from 3.3% in July to 4.4% in August; highly indexed items rose from 4.6% to 4.7%; those most affected by the exchange rate (via costs) from 4.2% to 4.3%; and the rest from 7.2% to 7.3%. Within the latter group, the increases that take place during Colombian soccer finals are very high, especially when the teams from the major cities participate, and have not fallen completely afterwards.

47. Within the group of regulated items, annual adjustment moved from 3.0% in July to 3.1% in August (**Table 3**). The annual variation of this component of the CPI has remained below the figure observed in December, thanks to the fact that during the first quarter of this year there were major falls in the price of gasoline. The rebound is associated, to a large extent, with the increase in the rates of public utilities (from 5.4% in July to 5.6% in August).

48. The increase in the rates of public utilities is mainly explained by the increase in the CPI for gas (from 16.5% in July to 18.4% in August). The annual variation of fuels tended to a slight increase, but remained negative (-5.3%). The annual variation for transportation remained at 4.1%.

49. In August, annual food inflation (6.1%) increased versus July (5.7%), also surpassing the record for last December (4.7%). In terms of components, it was noticed that processed items increased from 5.7% in July to 6.1% in August, due to other groceries, cold fast foods, sugar, and oils. Rice, which had strongly propelled the CPI for processed foods at the beginning of the year, fell again in August 1.53%. Also, perishable foods also contributed to increase food inflation, growing 9.9% annually in August compared to 8.0% in July. This is explained by the increases that beans have been building up, which in the past twelve months exceeded 68.0%, as well as by those of fresh vegetables that reached 39.0%. The supply of potato continued to be abundant and in August its price fell 11.0%. Meals outside the home remained stable at 4.5%.

50. In the past three months, pressures from non-labor costs have been increasing, as indicated by the new increase in the annual variation of producer prices (PPI) for domestic supply (produced and consumed plus imported goods) from 6.4% in July to 8.1% in August. This new increase is associated particularly with the depreciation of the peso *vis-à-vis* the US dollar, which thrust the PPI for imported goods again from 16.9% in July to 22.4% in August. In the local sub-basket of the PPI, the increase is explained by the industry (from 2.9% to 3.4%). Contrastingly, in August, the agricultural segment of the local PPI slowed down (from 7.0% to 6.0%), as did the mining sector (-3.0% to -3.6%).

51. With information to July and August, wages continued showing adjustments which were compatible with the target range for inflation. Those for heavy construction and housing continued without significant changes during August. Retail trade, for its part, exhibited a deceleration of 4.3% in June to 3.4% in July, with growth rates lower than those of last December (6.9%). As

for those for industry, recent information cannot yet be contrasted with past data due to the fact that at the beginning of this year the samples of wages from the industry were changed. (A comparison will be possible since next year).

52. Inflation expectations to December this year obtained from the monthly survey to financial analysts, with information to the second week of September, picked up substantially between August (4.21%) and September (4.72%). The expected inflation to twelve months, obtained from the same survey, also rose from 3.47% in August to 3.60% in September. In turn, so far in September, average inflation expectations to 2, 3, 5 and 10 years have increased 49, 52, 54 and 47 bp, respectively, compared to the average data of August. Thus, break-even inflation (BEI) to 2, 3, 5 and 10 years were placed at 4.18%, 4.14%, 4.20% and 4.63%, respectively.