



PUBLIC VERSION

Working Papers from the
Board of Directors
Banco de la República

Monetary Policy Report



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Economic Studies Division

MAY 2015

I. External Context and Balance of Payments

1. So far in June, the average international price of oil is slightly below its record of May, although it is still above the forecasts of the technical staff at the Central Bank of Colombia. The decision made by the Organization of Petroleum Exporting Countries (OPEC) to not reduce their production quota, the appreciation of the US dollar, and the lower demand for oil explain this fall to a great extent.
2. On the other hand, the prices of nickel and other metals exported by some countries in the region have fallen, and those for coffee and some food imported by Colombia continue at low levels.
3. The recent dynamics in the prices of goods exported and imported by the country indicates that the terms of trade in 2015 will be significantly lower than in the previous year, and similar to those registered at the beginning of 2009. This will continue affecting national income adversely.
4. The most recent registers for global economic activity show that growth of Colombia's main trading partners for 2015 would be lower than in the previous year and the one projected by the technical staff at *Banco de la República* in the March edition of the Inflation Report. The figures available for the second quarter suggest that reactivation of real activity in the United States would be weaker than expected, while the euro zone would have continued expanding at very modest rates. Meanwhile, the economy of China would have continued slowing down.
5. In the United States, the data for retail sales and housing market to May exhibited some improvements, although they continue growing at moderate rates. Meanwhile, industrial production continued slowing down. As for the labor market, employment generation continues at a favorable rhythm, so the unemployment rate for May registered low levels (5.5%). Regarding inflation, its annual register passed from -0.2% in April to 0% a month later, thanks to a large extent, to the increase in the price of fuels. Excluding energy and food, inflation decreased 0.1 percentage points, registering 1.7%.
6. In this context, the press release and the projections of the members of the FOMC (Federal Open Market Committee) of the Federal Reserve (Fed) suggest that the benchmark interest rate could be raised towards the end of the year, but that the increases would take place more gradually than was stated in the meeting of March.

7. In the euro zone, data for real activity, confidence indicators, and industrial surveys for the second quarter suggest that the economy would have continued reactivating slowly. Nevertheless, the possibility of Greece defaulting its credit liabilities in the absence of a settlement with its creditors, presents a greater risk for the economic recovery of the region. With respect to annual inflation, it increased to 0.3% in May mainly as a consequence of the increase in the price of fuels. Excluding foods and fuel prices, core inflation registered 0.9%.
8. In China, the data for May indicate that economic activity continued showing a historically low dynamism: the annual growth rate of industrial production and retail sales remained at their lowest levels since 2008, while investment in fixed assets showed a clear downward trend. On the other hand, annual inflation in May reduced to 1.2%.
9. In Latin America, the figures of economic activity for April suggest some recovery in Chile and Peru during the second quarter. However, these economies would continue expanding at relatively modest rates. In turn, the registers for Brazil indicate a greater fall.
10. Inflation in Latin American economies continued exhibiting a heterogeneous behavior. In Chile and Mexico it reduced and is within the target range of their respective central banks, while in Peru it increased. In contrast, annual variation of prices in Brazil remains high and with a growing trend.
11. As for international financial markets, the rates for long-term bonds of the main countries of the euro zone and the United States increased in the first weeks of June, thanks to the expectation that the economic recovery in Europe would continue and to the good registers for employment in the United States. Nevertheless, these rates have shown some declines over the last few days, as a result of a greater risk aversion due to the uncertainty generated by the situation in Greece. In this context, the US dollar has appreciated so far in June vis-a-vis its average in May.
12. In Latin America, the average of the risk premia increased slightly in June so far, while the currencies of the region have depreciated. In the case of the Colombian peso, the average value so far in June is of COP \$2,558 per US dollar, which represents a 4.8% depreciation of the price in May.

a. Exports and imports

13. In April, total exports recorded an annual fall of 25.6%, explained by a generalized decrease in the main items: the reduction in mining goods was of 35.9%, and external sales of other exports and that of agricultural goods presented variations of -3.2% and -3.3%, respectively. The fall in mining goods is associated to the lower exports of oil (-44.3%) and oil derivatives (-48.7%). In turn, exports of agricultural goods recorded falls in coffee (-19.3%) as well as in flowers (-5.6%).
14. Within other exports, significant falls were recorded in foods and beverages (-14.8%) and vehicles (-42.9%). In the first case, the falls registered towards the Netherlands (-58.3%) and Venezuela (-25.9%) stand out. In the case of vehicles, the main falls took place towards Mexico (-96.9%) and Peru (-44.5%). It is noteworthy that exports of other products towards the United States grew 0.2%, and those to Ecuador increased 6.0%.
15. So far this year to April, total exports fell 28.9%. Exports of mining goods (-40.2%) and those of other products (-9.4%) contributed to this fall. Exports of agricultural goods increased 16.9%. The negative variation of exports of mining goods was due to the lower value of oil exported (-47.1%), refined products (-60.5%), and gold (-37.8%). Among other exports, the falls in food and beverages (-9.1%), chemical products (-3.3%), meat (-61.7%), and paper (-18.2%) stand out. Exports of agricultural goods rose thanks to the increases in coffee (28.9%), banana (10.8%), and flowers (2.8%).
16. In April, total CIF imports recorded an annual variation of -18.2%. This reduction is explained by the fall of imports of capital goods (-23.2%), intermediate goods (-17.5%), and consumption goods (-12.3%). In the case of the imports of capital goods, the fall is explained, to a great extent, by the falls registered for transportation equipment (-48.6%) and capital goods for the industry (-12.0%).
17. Imports of raw materials and intermediate products recorded significant falls in raw materials for the industry (-17.2%) and fuels and lubricants (-21.6%). The lower imports of consumer goods are explained by the falls in the purchases of durable goods (-16.5%) and non-durables (-7.8%).
18. So far this year to April, CIF imports fell 8.1%. This fall is explained by the reduction of imports of intermediate goods (-16.0%), consumption goods (-2.0%), and capital goods (-1.0%). The main fall within intermediate goods was recorded in fuels and lubricants (-39.5%), while the fall in consumption goods is explained by the 6.7% fall in durable consumption goods. The fall in capital goods is explained mainly by the 9.0% fall in the purchases of capital goods for industry.

II. Growth, Domestic Demand, and Credit

19. As per the most recent information published by DANE, during the first quarter of the year the Colombian economy exhibited a yearly growth rate of 2.8%, which represented a slowdown vis-a-vis the data towards the end of 2014. This figure was similar to the midpoint of the growth range presented by the technical staff in the previous quarterly Inflation Report (between 2.0% and 3.5%, with 2.7% as the most probable figure). Quarterly growth was 0.8%, which in annualized terms corresponds to a 3.3% increase.
20. As for expenditure, domestic demand slowed down vis-a-vis the registers of the fourth quarter last year, while at the same time net exports continued contributing negatively. In the first case, the lower growth mainly resulted from a lower dynamics of public consumption. Private consumption and investment also slowed down, although to a lesser degree (Chart 1). In general terms, a lower growth of imports in constant pesos was expected, which at the same time would be the result of a significant moderation of investment. However, the slowdown of the gross fixed capital formation did not materialize at the pace foreseen in the previous Inflation Report.

Chart 1

	2013	2014				2014	2015
	Whole year	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Whole year	1st Quarter
Total consumption	5.0	5.3	4.3	4.4	4.9	4.7	3.3
Household consumption	3.8	4.2	3.8	4.1	5.3	4.4	3.9
Non-durable goods	3.2	3.7	3.0	3.9	4.8	3.8	3.4
Semi-durable goods	2.7	4.0	3.6	3.4	7.3	4.6	4.2
Durable goods	7.4	4.1	4.9	8.1	13.0	7.6	3.0
Services	4.3	5.0	4.1	4.0	4.1	4.3	4.0
Final government consumption	9.2	9.5	6.6	5.3	3.8	6.2	2.3
Gross capital formation	5.6	14.5	13.3	10.4	8.8	11.7	7.2
Gross capital formation	6.0	13.3	8.6	11.8	10.1	10.9	6.0
Farming, forestry, hunting and fishing	-5.7	3.6	3.0	4.7	7.1	4.6	-2.3
Machinery and equipment	0.2	14.4	7.8	14.6	12.2	12.2	1.5
Transportation equipment	-8.5	5.2	11.1	14.9	16.6	12.1	30.3
Construction and buildings	11.1	7.1	1.2	15.3	7.5	7.8	2.2
Civil works	10.8	25.9	13.6	6.6	3.6	12.1	6.9
Services	4.1	5.9	1.7	4.9	1.5	3.5	1.8
Domestic demand	5.1	7.8	6.0	5.9	5.8	6.3	4.2
Total exports	5.3	3.1	-12.1	4.2	-0.6	-1.7	1.3
Total imports	6.4	9.0	5.0	8.1	14.4	9.2	8.1
GDP	4.9	6.5	4.1	4.2	3.5	4.6	2.8

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

21. On the side of supply, the sectors that grew the most were retail, construction, and the financial sector. Industry and mining exhibited yearly setbacks (Chart 2). Tradable and non-tradable GDP slowed down again: the first one passed from 0.8% to 0.3%, while GDP of non-tradable goods passed from 5.3% to 4.4%.

Chart 2

Branch	2014					2015
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Whole year	1st Quarter
Farming, forestry, hunting and fishing	6.1	0.4	2.0	0.7	2.3	2.3
Mining and quarrying	6.0	(2.1)	(1.2)	(3.3)	-0.2	(0.1)
Manufacturing industry	4.0	(1.7)	(0.7)	(0.5)	0.2	(2.1)
Electricity, gas and water	4.5	3.7	4.0	3.0	3.8	2.0
Construction	14.0	8.7	10.9	6.1	9.9	4.9
Buildings	7.0	1.0	14.2	7.3	7.4	2.1
Civil works	24.5	14.6	6.7	4.2	12.0	7.0
Trade, repairs, restaurants and hotels	5.4	4.1	4.4	4.4	4.6	5.0
Transportation, warehousing and communication	4.9	4.3	4.2	3.2	4.2	2.8
Financial, real estate and corporate services	5.4	5.5	4.5	4.1	4.9	4.4
Social, community and personal services	7.4	5.4	4.7	4.4	5.5	3.0
Subtotal value added	6.3	4.0	4.1	3.2	4.4	2.7
Taxes minus subsidies	7.5	8.2	7.4	8.2	7.8	4.3
GDP	6.5	4.1	4.2	3.5	4.6	2.8

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

22. The scarce information available on economic activity for the second quarter of the year suggests that GDP would have continued expanding at a slow pace.
23. According to the Monthly Survey of Retail Trade (EMCM) from DANE, total retail sales without fuels fell 0.5% on a yearly basis in April 2015, vis-a-vis 5.5 on a yearly basis in the first quarter. This supports the lower forecasts for private consumption for the second quarter with regard to what had been observed toward the end of 2014 and the beginning of 2015. Excluding vehicle sales, a slowdown was also recorded during the same month, from 8.1% in the first quarter to 3.2%.
24. In turn, in April, vehicle sales fell 16.2% on a yearly basis, as reported by the same survey. Consistent with this information, the figures published by the Comité Automotor Colombiano (CAC) confirm that car retail sales in May fell 13.2% on a yearly basis (-8.9% only for private vehicles). A fall of greater magnitude was observed for wholesale vehicle sales, which recorded a 19.4% setback vis-a-vis the same month of 2014.
25. In April, the behavior of the question regarding the balance of sales from the Monthly Economic Expectations Survey (EMEE) from Banco of the República did not exhibit significant changes with respect to the data of March. Should this

situation continue, a slowdown of private consumption would take place again during the second quarter of 2015.

26. As for the labor market, although the unemployment rate (UR) continued showing significant yearly falls in the moving-quarter series, yearly increments also took place in the month of April. It should be considered that the monthly series contain a greater statistical error.
27. With information to the moving quarter ended in April, it is possible to state that the falls of the UR are explained by increases in salaried employment. On the other hand, in general, wage adjustments are at levels that do not compromise the inflation target.
28. Consumer confidence in May showed a slight recovery vis-a-vis the registers in April and March, according to the information published by Fedesarrollo. However, the level of the indicator continues below the average calculated since 2001. The indexes of economic conditions (IEC) and consumer expectations (ICE) exhibited levels close to the average registered for the first quarter.
29. On the other hand, slowdown in the growth rate of household credit continued in May. The consumption loan portfolio (in nominal terms) grew 12.6% in this month, a figure lower than the record of April (13.0%) and than the average for the first quarter of the year.
30. As for investment indicators, the balance of investment expectations of the EMEE in April suggests that gross fixed capital formation, other than construction of buildings and civil works, could register new slowdowns.
31. In turn, the data for retail sales of working vehicles to May reported by the CAC suggest that investment in transportation equipment (different to the one destined to airplanes) could record a lower dynamism during the second quarter of the year.
32. On the supply side, the industrial manufacturing index by DANE fell 3.6% on a yearly basis in April, a figure lower than the one expected by the technical staff at the Central Bank (-1.4%). The trend component of the series shows a significant contraction of the sector. So far this year, the fall is around 2.4%. Excluding oil refining, the rest of the manufacturing industry exhibited a fall of 2.1% in April, but so far this year shows a slight increase (0.5%). Although the trend for this series is not decreasing (as in the previous case), it does suggest a year-long accumulated stagnation.

33. The results for the subgroups of the manufacturing industry are heterogeneous: while oil refining (-11.1%), other food products (-15.1%), and beverages (-6.2%) reported significant setbacks, other activities related to chemical substances (18.0%) and pharmaceutical products (10.4%) exhibited an important increase. In April, 23 out of the 39 sub-sectors exhibited a fall in production.
34. As for construction, cement production grew 2.7% in April, but slowed down significantly vis-a-vis the previous quarter (7.8%). Nevertheless, the trend component keeps growing. Something similar happened to dispatches, which grew 4.4% vis-a-vis 8.1% in the previous quarter. On the contrary, the statistics for concrete production, with information to April, exhibit a more favorable performance with an annual growth of 3.5%, while in the first quarter its average was 2.1%.
35. In May, total electric energy demand increased 3.9% versus the same month last year. The trend component improved slightly and continues showing a positive slope. In turn, the demand of electric energy for industry fell 4.1% yearly, and its trend component shows a significant contraction.
36. As for the mining industry, oil production grew 7.9% on yearly basis in May, and for eighth consecutive month remained above one-million barrels (1,025,000). So far this year, the average production registered 1,026,500 barrels a day, a figure higher than the one considered in the central GDP forecast setting (1,020,000). It is worth noting that the favorable behavior of production could be affected in June by attacks to the infrastructure.
37. On the other hand, according to the information from the Federación Nacional of Cafeteros, coffee production increased 11.1% in May vis-a-vis the same month of 2014. So far this year, production is slightly over five million bags, which represents an annual expansion of 8.9%.
38. Considering this, it is foreseen that economic activity would expand at a moderate pace during the second quarter of the year. The possible impact on the dynamism of the mining sector and oil exports due to recent attacks to the oil infrastructure adds to the recent unfavorable situation faced by the industry, and the mediocre behavior of retail sales. All this would confirm some of the downward growth biases presented in the previous quarterly report. However, the information is still insufficient, and the outreach of these events on GDP growth will be revised in the next quarterly Inflation Report.

III. Behavior of Inflation and Prices

39. In May, annual consumer inflation fell after eight months of consecutive increases. The figure for this month, 4.41%, was lower by 23 basis points (bp) compared to the data from last month (Chart 3). For the year-to-date, increase of the CPI amounted to 3.2%. Market analysts as well as the technical staff expected a downturn, although the final result was lower than expected. Thus, the monthly variation amounted to 0.26% versus a forecast of 0.32% by the analysts.
40. The reduction of yearly consumer inflation in May was possible thanks to a reduction of the annual variation in the price of food. Acceleration was observed for the other three main groups in which the technical staff breaks down the CPI (regular, tradables, and non-tradable goods).
41. In May, core inflation continued increasing. The average of the four indicators estimated by the Central Bank registered 3.99%, vis-a-vis 3.84% the month before. This time, all the indicators increased, while the annual variation of the CPI excluding fuel, perishable foods and public utilities and of the core-20 was above the ceiling of the target range. In turn, inflation excluding food and regulated goods registered 3.8%, while that excluding food reached 3.7%, the latter being 28 bp higher than the data from the prior month (Chart 3).

Chart 3

Inflation to May 2015

Description	DEC 2013	MAR 2014	JUN 2014	SEPT 2014	DEC 2014	JAN 2015	FEB 2015	MAR 2015	APR 2015	MAY 2015	Participation in monthly acceleration (%)	Participation in acceleration so far this year (%)
Total	1.94	2.51	2.79	2.86	3.66	3.82	4.36	4.56	4.64	4.41	100.00	100.00
Non-food Inflation	2.36	2.62	2.66	2.70	3.26	3.20	3.41	3.46	3.44	3.72	(83.81)	42.21
Tradables	1.40	1.65	1.94	1.59	2.03	2.28	3.26	3.46	3.64	3.73	(9.05)	52.65
Non-tradables	3.76	3.55	3.45	3.26	3.38	3.47	3.50	3.56	3.67	3.83	(22.49)	18.93
Regulated items	1.05	2.21	2.14	3.25	4.84	4.01	3.47	3.25	2.68	3.45	(52.27)	(29.37)
Food Inflation	0.86	2.23	3.11	3.25	4.69	5.41	6.77	7.37	7.70	6.16	183.81	57.79
Perishables	(0.16)	3.17	8.92	7.61	16.74	16.78	19.68	21.57	16.99	8.34	146.18	(34.37)
Processed food	(0.24)	0.92	1.44	2.14	2.54	3.70	5.62	5.99	7.00	6.55	28.63	81.10
Eating out	3.26	4.13	3.52	3.23	3.51	3.60	3.34	3.59	4.68	4.45	9.00	11.05
Core Inflation Indicators												
Non-food Inflation	2.36	2.62	2.66	2.70	3.26	3.20	3.41	3.46	3.44	3.72		
Core 20	2.72	2.86	3.04	2.89	3.42	3.58	3.62	3.70	3.97	4.06		
CPI excluding perishable foods, fuels and utilities	2.19	2.53	2.53	2.39	2.76	3.12	3.69	3.95	4.29	4.38		
Inflation excluding foods and regulated items	2.74	2.74	2.81	2.55	2.81	2.97	3.40	3.52	3.65	3.79		
Average of Core Inflation Indicators	2.51	2.69	2.76	2.63	3.06	3.22	3.53	3.65	3.84	3.99		

Source: DANE. Calculations by BANCO DE LA REPÚBLICA

42. Among the CPI excluding food, acceleration of the annual variation of regulated goods stood out, mainly due to the increase of electric energy rates, and, to a smaller extent, to residential gas rates. Annual adjustments in both cases are high (7.9% and 13.4%, respectively). As opposed to gas rates, which have increased significantly so far this year, increases in electric energy (which explain the high

annual variation) took place in the second semester last year. It is worth noting that adjustments in the rates of electric energy have been highly volatile, which makes it difficult to identify its trend. On the other hand, up to date it is not possible to state that the presence of El Niño is impacting the determination of the prices of public utilities, although this is a risk that could materialize in the second semester.

43. Increases in the prices of non-tradable goods and services (excluding food and regulated goods) that had not been anticipated also took place in May. These were registered in leases, vehicle insurance, services related to leisure activities (soccer tickets), and services related to personal care, among other items. Due to this, annual variation of this subgroup increased to 3.8% (16 bp higher than last month) (Chart 3).
44. From the end of last year, annual variation of the CPI of non-tradable goods has exhibited increases that have turned out to be greater than the forecasts of the technical staff. Three factors explain this behavior: the first one of them is associated with punctual adjustments in some items of the CPI (mainly soccer tickets) that may be assimilated to transitory shocks; the second one, related to the depreciation of the peso through several prices (such as those of furniture and TV services) which, being within the group of non-tradable goods, end up being influenced by the movement of the exchange rate. The third one would be associated to the increase of inflation expectations and with the persistence of indexing phenomena, factors that would weigh more in service items such as education and health. With the information available it is not clear that the increases in the group of non-tradable and regulated goods comply mainly with demand pressures. The technical staff at Banco of the República estimates a slightly negative output gap for the beginnings of 2015.
45. In May, annual variation of the CPI for tradables (excluding food and regulated goods) accelerated to 3.7%, from 3.6% in the previous month. This result was similar to the one projected by the short-term models of the technical staff. This indicator has increased gradually since September last year, when it registered 1.6%, as a response to the depreciation of the peso. This time, the prices for newspapers, electric appliances, vehicles, electronic items, and alcoholic beverages, among others, increased.
46. Annual variation of food exhibited a significant downturn in the last month, after increasing consecutively for several months. The data for May reached 6.2% (Chart 3), falling 154 bp vis-a-vis April.

47. Most of the fall in this group during May concentrated on perishable foods (from 18.0% in April to 8.3%). Particularly, falls in the prices of potato and other tubers took place as well as in several fruits and vegetables, which partly reverted the increases that had taken place in previous months. The yearly variation of the CPI for processed foods and that for foods out of the home also decreased. In the first case, thanks to a reduction in the price of the rice (although small compared with the previous increases), and slight adjustments in the prices of meat and milk. However, it is noteworthy in this subgroup that the prices of imported foods such as cereals and oils increased again at rates higher than in the past, which is related to the accumulated depreciation of the peso.
48. In this context, inflation expectations for the end of this year remained relatively stable to different horizons. The monthly survey by the Central Bank to financial market analysts shows an expected average inflation of 3.88% for December 2015, vis-a-vis 3.92% obtained in the previous month. In a twelve-month horizon, the inflation expected is 3.17%, which is very similar to the previous survey (3.16%). Similarly, two-year expectations obtained from the same survey remained at 3.0%. On the other hand, inflation expectations embedded in the public debt bonds for 2, 3, and 5-year horizons have declined so far in June to 6.6 bp, 5.1 bp, and 0.5 bp, respectively, as compared to the average data from May. For the 10-year horizon they increased 7.4 bp. Thus, break even inflation to 3, 5 and 10 years registered 3.31%, 3.19%, 3.25%, and 3.89%, respectively.
49. Inflationary pressures originated in non-labor production costs have yielded in recent months, judging by the behavior of the PPI. Annual variation descended once more in May, registering at 3.7% versus the result from a month before (4.3%) and a maximum of 6.4% in January this year. The downturns in this variable are explained both by the group of imported goods, as well as by that of produced and consumed goods, the latter including the agricultural PPI.
50. In turn, labor costs are still compatible with the inflation target, according to the information available on salaries for construction and retail, which continue adjusting to rates between 4.0% and 4.5%.