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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 data available suggest that growth of the country's trading partners continues to be very modest, according to the forecast of the December Inflation Report. However, the data from the advanced economies so far in 2017 indicate that an improvement in their economic activity is taking place. Specifically, the American labor market data for February were better than expected (235 thousand jobs were generated, while 200 thousand had been forecast) and the manufacturing PMI in the euro zone in February would have reached the highest record of the past 70 months. In Latin America, the available data suggest that growth continues to be mediocre.
2. In most advanced economies, inflation keeps an upward trend. In the United States, to February, annual inflation posted at 2.7%, and it is expected to continue above 2.0% during 2017. Although inflation in the euro zone shows a rising trend and reached 2.0% in February, core inflation remains relatively stable. In Latin America, inflation has decreased or stabilized in most countries, except for Mexico, where significant increases have been observed in the first months of the year.
3. The Federal Reserve increased the benchmark interest rate at its March meeting, as expected by the market. Based on the *communiqué* announcing this decision, analysts interpreted that the increase would take place more gradually than expected by the market in the last few weeks. On the other hand, the market anticipates the European Central Bank (ECB) to be less expansive in the future, as it could be considering increases in its benchmark policy rate even before the end of its asset-purchase program.
4. Also, during the first weeks of March, the Latin American currencies depreciated. However, this trend was reversed in the last few days, despite the increase in the Fed’s interest rate.
5. On March 8, international oil prices showed a significant fall in response to the news of higher inventories in the United States. Subsequently, the declining trend in the price has continued.
6. The rates of bonds in developed economies remain at levels higher than those observed in recent years. Additionally, so far in 2017, the global stock exchange indices continue to exhibit a positive trend. In Europe, a significant drop in financial volatility indicators was noted, which is explained by the electoral results in the Netherlands.

Exports (**Table 1**)

7. In January, exports in US dollars registered an annual growth rate of 39.9% due to increases in all groups of goods. The annual increase in the external sales of mining goods (68.1%) and agriculture (34.4%) stands out (**Table 1**).
8. The annual growth of total exports is explained by the effect of prices (the index rose 44.6% per year versus a 3.3% decrease in the one for quantities), concentrated in the mining group (the price index increased 77.9% on a yearly basis versus -5.5% for quantities). On the other hand, the increase in the sales of agricultural goods responded to a joint effect of prices (16.3%) and quantities (15.5%).

Table 1: Behavior of Exports in US dollars

January 2017				
	Annual Variation (Contribution)	Main items contributing to annual variation:		
		Item	Annual variation of the item	Contribution to annual variation
Total	39.9%			
Agricultural goods	34.4%	Coffee	44.5%	3.7
		Banana	47.3%	1.0
		Flowers	8.4%	0.4
		Contribution of the group:		5.1
Mining goods	68.1%	Crude oil	64.1%	17.3
		Coal	81.6%	10.3
		Refining	79.2%	4.4
		Gold	65.0%	2.6
		Ferro-nickel	-30.8%	-0.4
		Contribution of the group:		34.1
Other exports*	2.0%	Metal manufacturing	50.3%	0.4
		Foods, beverages and tobacco, excluding coffee	5.6%	0.4
		Other products	311.9%	0.4
		Other exports mining sector	-85.3%	-0.6
		Machinery and equipment	-31.1%	-0.8
		Contribution of the group:		0.7

* Within this group, the destinations which contributed the most to growth were United States, Mexico, and Perú, with annual increases of 10.5%, 70.2%, and 19.4%, respectively. Venezuela continues to exhibit annual decreases (76.2% in January).
Source: DANE

9. The price index for total imports registered a 3.0% annual fall, while the volume index increased 3.3%. This would show that imports increased on account of quantities.
10. According to the preview for foreign trade by DIAN, in February, exports excluding oil and its derivatives increased 3.1% on a yearly basis (according to this source, they had grown 26.3% in January; however, the increase reported later by DANE was 27.0%).

Imports (**Table 2**)

11. In January, CIF imports in US dollars registered an annual 0.3% increase, to which external purchases of consumption goods and intermediate goods contributed positively (11.1% and 2.2%, respectively). Imports of capital goods fell 9.2% annually (**Table 2**).
12. According to the preview for foreign trade by DIAN, CIF imports recorded an annual 8.5% growth in February. (According to this source, they would have fallen 0.2% in January; however, the figure reported later by DIAN was a 0.3% increase).

Table 2 Behavior of Imports in US dollars

January 2017				
	Annual Variation	Main items contributing to annual variation:		
		Item	Annual variation of the item	Contribution to annual variation
Total	0.3%			
Capital Goods	-9.2%	Transport equipment	-60.0%	-2.9
		Industrial machinery	-17.9%	-1.5
		Office machinery and equipment	-4.2%	-0.2
		Contribution of the group:		-3.1
Raw Materials	2.2%	Chemical and pharmeceutical products	7.8%	1.1
		Mining products (for industry)	6.7%	0.5
		Food products	7.6%	0.5
		Fuels	-27.5%	-2.3
		Contribution of the group:		1.0
Consumer Goods	11.1%	**Non-durable consumer goods**	**7.9%**	**0.9**
		Food products	20.2%	0.8
		Beverages	31.1%	0.2
		Durable consumer goods	**14.8%**	**1.5**
		Vehicles for private use	21.1%	1.2
		Decoration, personal use, and other objects	11.7%	0.2
		Contribution of the group:		2.4

Source: DANE

13. Regarding the balance of payments, during 2016, the current account recorded a deficit of USD $12,541 m, lower by USD $6,239 m than a year ago (Table 3). As share of GDP, it stood at 4.4%, which meant a 2.0 pp reduction compared to the deficit in 2015. The lower current account deficit was the result of a significant drop in outflows (USD $10,180 m), which more than offset the reduction in income (USD $3,940 m) especially due to the fall in exports of goods.
14. By components, the reduction of the deficit was explained by the lower imbalance of trade in goods (USD $3,709 m) and services (USD $1,516 m), by

lower net outflows of factor income (USD $616 m), and by the increase in income from transfers (USD $398 m).

15. As for the financial account, in 2016 capital flows recorded net inflows of USD $12,764 m, of which USD $24,108 m corresponded to foreign capital income and USD $11,820 m to outflows of Colombian capital to purchase assets abroad. Of the total income, foreign direct investment (FDI) was the main source of funding (56%), followed by the investment portfolio in the local market with 24%, mostly purchases of TES by foreign investors. The issuance of bonds in international markets accounted for 12%, while the remaining 8.0% was due to external loans and other credits, mainly with multilateral banks.
16. Compared to a year ago, during 2016 the financial account of the balance of payments registered lower net capital flows by USD $5,529 m. This was due mainly to the increase in Colombian capital outflows to purchase assets abroad, although there was also a slight reduction in foreign capital inflows.

Table 3: Balance of Payments Current Account

BALANCE OF PAYMENTS - (Millons of USD)	2015	2016	Variation
CURRENT ACCOUNT (A+B+C+D)	**-18,780**	**-12,541**	**6,239**
Percentage of GDP	**-6.4**	**-4.4**	**2.0**
A. Goods	**-13,970**	**-10,261**	**3,709**
a. Exports	38,080	32,965	**-5,115**
Main products	23,854	19,712	**-4,141**
Other exports	14,226	13,253	**-973**
b. Imports	52,050	43,226	**-8,824**
B. Non-factor Services	**-4,536**	**-3,020**	**1,516**
C. Factor Income	**-5,526**	**-4,910**	**616**
D. Current Transfers	**5,251**	**5,650**	**398**

II. Growth, Domestic Demand and Credit

17. The information available of supply and demand suggests that the annual growth of the Colombian economy at the beginning of the year continued to be weak, and slightly lower than expected.
18. On the demand side, according to the Monthly Survey of Retail Sales (EMCM) by DANE, retail sales (excluding fuel) fell 1.4% compared to the same month in 2016. This figure represented a deterioration of the indicator, both of the level and growth *vis-à-vis* the fourth quarter of last year.
19. Excluding vehicle sales, the remaining aggregate decreased 0.7% on a yearly basis. The level in January was also lower than the one reached toward the end of last year. Additionally, the trend component of the series suggests stagnation

since mid 2016. The groups of goods with greater contributions to the fall were spare parts and vehicle parts, personal care products, and footwear and leather goods. This was not offset by the increase in sales of appliances and furniture for the home. It is worth noting that the sales of durable consumer goods of this type presented a significant increase in the months of November, December, and January, which may be due to the anticipation of this type of expenditure by families in response to the increase in the VAT.

20. Vehicle sales fell 6.0% on a yearly basis, subtracting 0.7 pp to the growth of the aggregate. The levels observed in the series are similar to those registered on average for the first part of 2016.
21. Something similar is suggested by the figure of the sales balance of the Monthly Survey of Economic Expectations (EMEE) by the Central Bank in January, which showed again stagnation in that month.
22. With information to February, the consumer confidence index (ICC) of Fedesarrollo recovered slightly versus the record of January, but remains at historically low levels, far from the average calculated since November 2001. The component of economic conditions did not change significantly compared to the previous month, while that of expectations showed some improvement, although it continued to be low.
23. Also with figures to February, the records of license registrations published by ANDI and Fenalco fell 11.6% on a yearly basis. This setback occurred for vehicles both for private use (-12.9%), and for commercial use (-9.9%).
24. The recent performance of the employment indicators also suggests a low dynamism of private consumption. With figures to January, few changes were observed in the trends for labor market indicators. Discounting the seasonal effect, the series for the unemployment rate show an upward trend for the national total and the thirteen areas, more stressed in the latter case. Additionally, it should be noted that in the moving quarter ending in January, there was a significant slowdown in salaried employment, and that the number for non-salaried employment increased *vis-à-vis* the previous month.
25. Thus, low dynamism of private consumption is expected during the first quarter of the year. Particularly, consumption of durable goods would not contribute significantly to the growth of this component of GDP.
26. Regarding the gross capital formation other than construction of buildings and civil works, in January, the balance of investment expectations of the EMEE posted a slight increase, although its trend component continues to exhibit falls. The behavior of imports of capital goods (in constant pesos) in January showed something similar. This suggests that this line of GDP would continue to contract during the first quarter, although at a slower pace than that of the fourth quarter of 2016.

27. On the supply side, the indicators available for the first quarter of the year suggest a further weakening in activities such as industry, mining, trade, and energy production. On the contrary, the figures for the agricultural sector show improvement.
28. According to DANE, in January, total industrial production (IPI) fell 0.2%. Part of the forecast error is explained by the forecast for oil refining. Excluding oil refining, the rest of the industry contracted at a yearly 0.6% rate. The trend component continues with a slightly positive slope.
29. In addition, the survey by Fedesarrollo for January suggests that, in the case of Industry, disparate behaviors were observed. While the indicator for orders improved slightly compared to the previous month, the one for stocks (which is counter-cyclical) exhibited deterioration, and its trend component suggests weakening of the sector. On the other hand, expectations diminished versus the previous month, but the high volatility in the indicator does not allow determining a clear trend. For the time being, the trend component does not suggest major changes in the trends observed. With this, in January, the business confidence indicator that is constructed on the basis of the variables mentioned above continued to fall. The data to February showed a new setback compared to a month ago.
30. Oil production continued to fall in annual terms (-12.9%), standing at 855 thousand barrels per day, a level similar to that of the past few months.
31. Regarding construction, in January, cement production and shipments fell 6.0% and 2.8%, respectively. Additionally, there was a 12% contraction in the same month for construction licenses (housing -4.5% and other destinations -29.7%).
32. With data to February, the total energy demand fell 5.0% annually. The trend shows a flattening. The regulated and non-regulated components fell 4.8% and 5.6% on a yearly basis, respectively.
33. In contrast to all of the above, coffee production was above 1 million 60-kg bags (1,293,000), which implied an 18.0% expansion in February. So far this year, production has increased 15.1%.
34. For 2017, a 2.0% growth is still expected for the whole year. The different components of demand would have a more balanced growth than observed in 2016. Particularly, a good performance of the investment in civil works is forecast, which would allow for a greater dynamism of investment. However, to date, there is no information regarding the recent performance of this sector.

III. Behavior of Inflation and Prices

35. Annual consumer inflation in February 2017 was 5.18%, lower than a month ago (5.47%). This completes seven months of uninterrupted declines from its

recent peak (8.97%) last July **(Table 4)**. Monthly variation was 1.01%, higher than expected both by the market (1.16%) and by the technical staff at *Banco de la República*. In the month, the fall of the total annual inflation is explained exclusively by the CPI of processed foods and regulated items.

36. The impact of the tax reform would have been felt during the first two months of the year (by the change in the VAT and the green tax), and the Liquor Act.

Table 4

Headline and Core Inflation to February 2017

Description	Weight	Dec 2015	Dec 2016	Jan 2017	Feb 2017	Participation percentage in monthly acceleration	Participation percentage in acceleration of the year to-date
Headline inflation	**100.00**	**6.77**	**5.75**	**5.47**	**5.18**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.17**	**5.14**	**5.26**	**5.17**	**21.60**	**0.13**
Tradables	26.00	7.09	5.31	5.37	5.75	**-28.35**	-15.39
Non-tradables	30.52	4.21	4.85	4.83	5.06	**-25.48**	-9.64
Regulated items	15.26	4.28	5.44	5.93	4.55	**75.43**	25.16
Food inflation	**28.21**	**10.85**	**7.22**	**5.97**	**5.21**	**78.40**	**99.87**
Perishables	3.88	26.03	-6.63	-10.15	-9.60	-11.52	29.94
Processed food	16.26	9.62	10.74	9.38	7.69	90.64	82.12
Eating out	8.07	5.95	8.54	9.26	9.31	-0.72	-12.19
Core inflation indicators							
Non-food inflation		5.17	5.14	5.26	5.17		
Core 20		5.22	6.18	6.18	6.03		
CPI excluding perishable foods, fuel and utilities		5.93	6.03	5.95	5.74		
CPI excluding food and regulated items		5.42	5.05	5.06	5.35		
Average of core inflation indicators		**5.43**	**5.60**	**5.61**	**5.57**		

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

37. Core inflation, measured by the average of the four indicators monitored by the Central Bank, did not exhibit any relevant changes in February, as had happened in January, remaining close to 5.60%.
38. In January and February, three of the four core inflation indicators fell. The CPI excluding food moved from 5.26% to 5.17%, the CPI excluding primary food, fuel, and public utilities moved from 5.95% to 5.74%, and the Core 20 moved from 6.18% to 6.03%, with the latter at the highest level. Contrastingly, the CPI excluding food and regulated items increased from 5.06% to 5.35% (**Table 4**).
39. Within the CPI excluding food, the annual variation in the group of tradables (excluding food and regulated items) increased from 5.37% in January to 5.75% in February. During these two months, there was a break in the decreasing trend exhibited by this indicator during the second half of last year, which was due to the fact that the pass-through of the accumulated depreciation of the peso since mid 2014 and until early 2016 was giving way. In the past two months, the impact of the tax reform and of the Liquor Act would have offset this trend.

40. The annual CPI adjustment for non-tradables excluding food and regulated items rose from 4.83% in January to 5.06% in February. This upturn is associated with the prices of rents, whose annual variation of 4.0% in January increased to 4.23% in February, and also with the increase of other indexed items from 6.15% to 6.91%. As for this case, there was a significant increase in the adjustments of education costs such as tuition and monthly payments from 6.2% in January to 7.0% in February. Also, regarding health, in services such as general and specialized medical consultation, supplementary payments and others, the adjustments remained above 6.0%. In these two cases, the 7.0% increase in the minimum wage and other wages (as shown below), as well as the activation of indexation mechanisms, would explain the increases well above the inflation target. It should be noted that these items in the health and education areas were not affected by the tax reform.
41. The CPI variation for regulated items declined in February *vis-à-vis* January (from 4.55% to 5.93%). This fall is explained by public utilities (from 6.35% to 4.14%) and transport (from 6.07% to 4.53%). In the first case, the CPI for energy fees fell in the month, thanks mainly to reductions in Bogotá and Barranquilla due to a lower cost of generation. As will be mentioned, these declines would be reversed to a great extent in March.
42. Within the group of regulated items, the sub-group of fuels increased (from 4.27% to 5.95%) on the basis of statistical comparison. No increase in the price of gasoline was decreed in February, which would suggest that to January, the COP $135 from the green tax had already been fully incorporated.
43. As for food, the strong decline in annual variation of its prices continued in February (5.21%, compared to 5.97% in January and 15.71% in the peak reached in July 2016). The favorable weather and the reversal of *El Niño*, the accumulated appreciation in the past twelve months to February (14.17%), and the increase in agricultural supply explain this behavior.
44. However, unlike previous months, the decline was concentrated in processed foods thanks to the good behavior of the prices of products such as sugar, rice, and chocolate, among others. Perishable goods, on the other hand, increased (from -10.15% to -9.60%) for the first time since July 2016. Meals outside the home maintained rises close to 9.3%. This item would have been driven by the 7.0% adjustment of the minimum wage and by increases in the price of meat (still above 17.0% on a yearly basis in February, despite some declines), although it cannot be ruled out that the tax reform also had an upward effect.
45. The pressures of non-labor costs continued easing in February, according to the annual variation of the PPI for domestic supply (domestically produced and consumed goods, plus imported goods). Annual variation of this indicator moved from 0.88% in January to -0.16% in February (**Table 4**). Annual variations in the components of the domestic and imported PPI (2.64% and -

6.15%, respectively), decreased again this month (59 bp and 198 bp, respectively).

46. In terms of labor costs, adjustments in the wages exhibited significant increases for trade and industry in January (7.5% and 6.9%, respectively), well above the 3.0% target. In February, the pace of adjustment of construction wages continued to fluctuate between 4.0% and 5.0%. Salary costs are emerging as a source of inflationary pressures in 2017, despite a loose labor market.
47. According to the latest monthly survey to financial analysts (applied at the beginning of March), inflation expectations to December 2017 dropped from 4.61% in February to 4.49%, as did the expectations to 12 and twenty-four months (from 4.09% to 3.85% and from 3.61% to 3.48%, respectively). Finally, on average, with data to 22 March versus the figures for February, Break-even Inflation expectations embedded in government bonds (TES) in pesos and UVR lowered 70, 56, and 35 bp for 2, 3 and 5-year terms, respectively. Thus, the averages for BEI so far in March for these terms stand at 4.0%, 3.72%, and 3.46%, respectively. Additionally, other inflation expectations indicators (Forward Breakeven Inflation, FBEI) to 2, 3, and 4 years are above -but closer to- the goal.