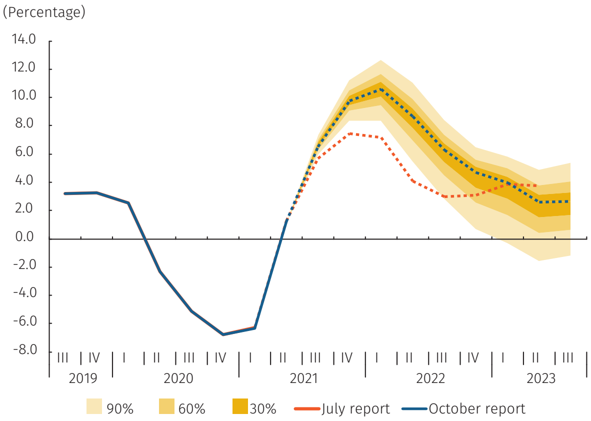
01/ Summary

1.1 Macroeconomic summary

Economic activity has recovered faster than projected, and output is now expected to return to pre-pandemic levels earlier than anticipated. Economic growth projections for 2021 and 2022 have been revised upward, though significant downward bias remains. (Graph 1.1). Colombia's economy returned to recovery in the third quarter after significant supply shocks and a third wave of COVID-19 in the second. Negative shocks affecting mobility and output were absent in the third quarter, and some indicators of economic activity suggest that the rate of recovery in demand, primarily in consumption, outpaced estimates from the July *Monetary Policy Report* (MPR) in the context of widely expansive monetary policy. Several factors are expected to continue to contribute to output recovery for the rest of the year and into 2022, including the persistence of favorable international financial conditions, an expected improvement in external demand, and an increase in terms of trade. Increasing vaccination rates, the expectation of higher levels of employment and the consequent effect on household income, improved investment performance (which has not yet returned to pre-pandemic levels), and the expected stimulus from monetary policy that would continue to be expansive should also drive economic activity. As a result, output is estimated to have returned to its pre-pandemic level in the third quarter (previously expected in the fourth quarter). Growth is expected to decelerate in 2022, with excess productive capacity projected to close faster than anticipated in the previous report. Given the above, GDP growth projections have been revised upward for 2021 (9.8%, range between 8.4% and 11.2%) and 2022 (4.7%, range between 0.7% and 6.5%). If these estimates are confirmed, output would have grown by 2.3% on average between 2020 and 2022. This figure would be below long-term sustainable growth levels projected prior to the pandemic. The revised growth forecast for 2022 continues to account for a low basis of comparison from this year (reflecting the negative effects of COVID-19 and roadblocks in some parts of the country), and now supposes that estimated consumption levels for the end of 2021 will remain relatively stable in 2022. Investment and net exports are expected to recover at a faster pace than estimated in the previous report. Nevertheless, the downward risks to these estimates remain unusually significant, for several reasons. First, they do not suppose significant negative effects on the economy from possible new waves of COVID-19. Second, because private consumption, which has already surpassed pre-pandemic levels by a large margin, could perform less favorably than estimated in this forecast should it reflect a temporary phenomenon related to suppressed demand as service sectors re-open (e.g. tourism) and private savings accumulated during the pandemic are spent. Third, disruptions to supply chains could be more persistent than contemplated in this report and could continue to affect production costs, with a negative impact on the economy. Finally, the

Graph 1.1
Gross domestic product, 4-quarter accumulated[a/, b/, c/]
(annual change)

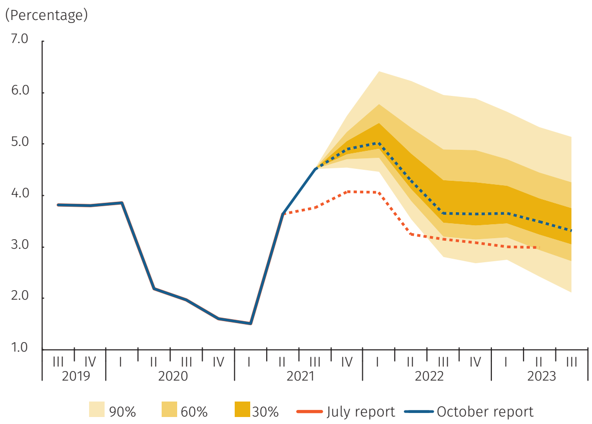


a/ This graph presents the probability distribution of the forecast on an 8-quarter time horizon. The density characterizes the prospective balance of risks with areas of 30%, 60% and 90% probability surrounding the central forecast (mode), through a combination of the densities of the Patacon and 4GM monetary policy models.
b/ Seasonally adjusted and corrected for calendar effects.
c/ The probability distribution corresponds to the forecast exercise in the October report.
Source: DANE; calculations and projections by Banco de la República.

accumulation of macroeconomic imbalances could translate to increased vulnerability to changes in international financial conditions or in international and domestic economic agents' perception of risk in the Colombian economy, representing a downward risk to growth.

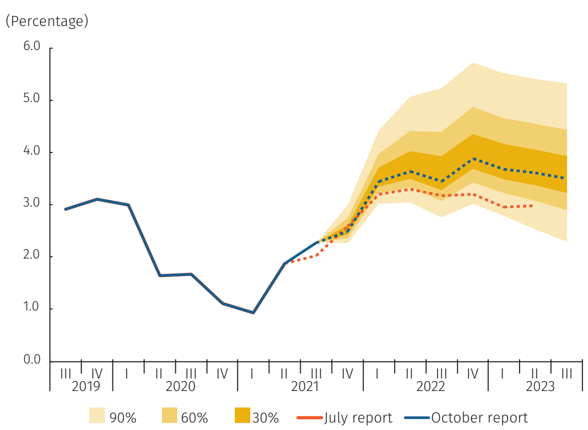
A higher-than-expected increase in inflation, the persistence of supply shocks, and reduced excess productive capacity have led to an increase in inflation projections above the target on the forecast horizon (Graph 1.2). Inflation increased above expectations to 4.51% in the third quarter, due in large part to the price behavior of foods and regulated items, and to a lesser extent to core inflation. Increased international prices and costs continue to generate upward pressure on various sub-baskets of the consumer price index (CPI), as has the partial reversion of some price relief measures implemented in 2020 in response to the COVID-19 pandemic. The inflation forecast has been revised upward due to external shocks that have proved more persistent than anticipated in the previous report and the effects of inflation indexation on some prices. Furthermore, excess productive capacity is expected to tighten at a faster pace than previously forecast, which would reduce downward pressures on core inflation. Given the above, overall year-end inflation is expected to reach 4.9% in 2021 and 3.6% in 2022. Core inflation (excluding foods and regulated items) for the same period is now forecast to be 2.5% and 3.9% (Graph 1.3), respectively, an increase due partly to temporary shocks associated with tax measures, such as the Colombian government's VAT-free days[1]. These estimates retain a wide margin of uncertainty, partially associated with the magnitude of excess productive capacity and the speed with which it can be expected to tighten. Additional sources of uncertainty are rooted in increased price and measurement volatility based on an extension of Colombia's health emergency status and tax relief measures approved as part of the government's Social Investment Law (*Ley de Inversión Social*) (e.g. VAT-free days), which could make estimating core inflation on the forecast horizon more difficult. A final source of uncertainty is based on the risk of more persistent supply shocks that would affect inflation expectations or increase indexation in some baskets of the CPI relative to the forecast.

Graph 1.2
Consumer price index a/, b/
(annual change, end-of-period)



a/ This graph presents the probability distribution of the forecast on an 8-quarter time horizon. The density characterizes the prospective balance of risks with areas of 30%, 60% and 90% probability surrounding the central forecast (mode), through a combination of the densities of the Patacon and 4GM monetary policy models.
b/ The probability distribution corresponds to the forecast exercise in the October report.
Source: DANE; calculations and projections by Banco de la República.

Graph 1.3
CPI excluding food and regulated items a/, b/
(annual change, end-of-period)



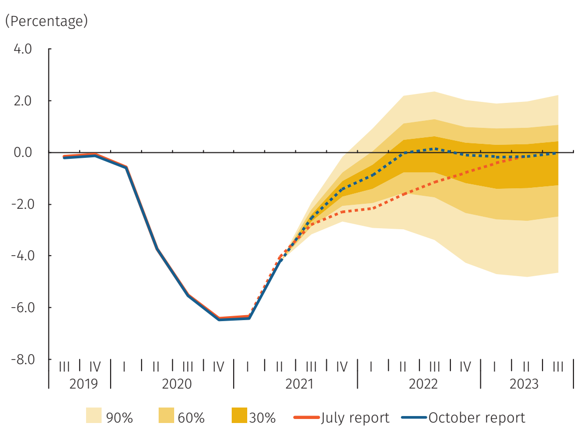
a/ This graph presents the probability distribution of the forecast on an 8-quarter time horizon. The density characterizes the prospective balance of risks with areas of 30%, 60% and 90% probability surrounding the central forecast (mode), through a combination of the densities of the Patacon and 4GM monetary policy models.
b/ The probability distribution corresponds to the forecast exercise in the October report.
Source: DANE; calculations and projections by Banco de la República.

International demand as it pertains to Colombia is expected to continue its recovery, amid increased pressure on global inflation rates. International financial conditions should continue to be favorable, though external financing costs are expected to increase on the forecast horizon. Growth among Colombia's major trade partners was higher than expected in the first half of the year, amid significant advances in

1 The 2021 forecast takes into account the three VAT-free days already decreed by the government, which could lead to significant declines in the CPI for this basket in the last quarter of the year. The 2022 forecast does not consider VAT-free days, as their dates or numbers have not yet been confirmed (the Social Investment Law considers three VAT-free days per year). This would be expected to generate a mechanical increase in core inflation in the fourth quarter of 2022, given the basis of comparison from this year.

vaccination programs, ample international liquidity, and a recovery in the trade of goods. Nevertheless, the propagation of new strains of COVID-19 and the persistence of global supply chain issues have moderated growth forecasts for the rest of 2021. Given the above, the growth forecast for Colombia's major trade partners has been revised from 6.0% to 6.3% for 2021 and from 3.5% to 3.4% in 2022. Colombia's terms of trade have increased due primarily to increases in oil, coffee, and coal prices, and despite increases in the price of goods and services imports. Oil prices are still expected to decline as challenges in gas and coal markets diminish, and as the global supply of crude oil increases. Increased freight prices and disruptions to supply chains continue to generate significant increases in global production costs, which, together with a recovery in global demand, has put upward pressure on external inflation. Numerous emerging market economies have begun to normalize monetary policy in this context. In the United States, markets expect higher inflation for 2021 and part of 2022, with tapering beginning at the end of this year and a first increase in the monetary policy interest rate at the end of 2022. Another increase would be expected in the middle of 2023. For its part, Colombia's sovereign risk premium has been higher than in the previous quarter, and the forecast in this report supposes a faster convergence to levels above its 15-year average, due in part to the accumulation of macroeconomic imbalances. International financial conditions are expected to continue to be loose, though to a lesser degree than projected in the previous report. The expected increase in Colombia's external financing costs could be more significant if upward pressures on inflation in the United States persist and the Fed normalizes monetary policy earlier than anticipated. In general, uncertainty remains unusually high in the global context, due to unknowns over the evolution of the pandemic, the persistence of disruptions to global supply chains, the impact of the energy crisis, and more significant deceleration in China, among other factors.

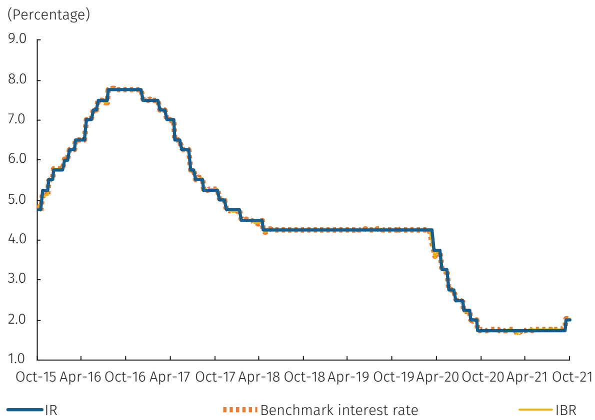
Graph 1.4
Output gap[a/, b/, c/]
(4-quarter accumulation)



a/ The historical output gap estimate is calculated as the difference between observed (4-quarter accumulation) and potential (trend, 4-quarter accumulation) GDP based on the 4GM model; the forecast gap is calculated as the difference between the technical staff's GDP estimate (4-quarter accumulation) and potential (trend, 4-quarter accumulation) GDP based on the 4GM model.
b/ This graph presents the probability distribution of the forecast on an 8-quarter time horizon. The density characterizes the prospective balance of risks with areas of 30%, 60% and 90% probability surrounding the central forecast (mode), through a combination of the densities of the Patacon and 4GM monetary policy models.
c/ The probability distribution corresponds to the forecast exercise in the October report.
Source: DANE; calculations and projections by Banco de la República.

Excess productive capacity has tightened faster than expected in the previous report (Graph 1.4). Overall and core inflation are both on growth trajectories, expected inflation has increased (though it remains close to 3% in the medium term), and monetary policy continues to be expansive. The unexpectedly high rate of economic growth and the evolution of some prices in the economy suggest that excess capacity is tightening faster than previously expected. At the same time, the improved performance of domestic demand has been reflected in an expansion of the current account deficit. Core inflation continues below 3%, but is trending upward, while expected inflation has increased but remains close to 3% in the medium term. However, the risk of more persistent supply shocks that would increase prices and affect inflation expectations, lead to higher indexation, and move inflation away from the target more persistently has increased. The labor market continues to be loose, though figures from September showed more significant recovery than previously expected. Given the above, the output gap is expected to remain negative, though to a lesser degree than previously forecast, while the temporary supply shocks that have affected inflation are now expected to be more persistent. As a result, the technical staff

Graph 1.5
Benchmark interest rate, interbank rate and IBR [a/]
(weakly data)



a/ IR: interbank rate; IBR: banking reference indicator; Repo: policy rate.
Sources: Financial Superintendent of Colombia and Banco de la República.

expects that the trade-off between excess productive capacity and inflation above the target to continue, but with a balance of risks inclined toward higher inflation rates.

1.2 Monetary policy decision

Banco de la República's board of directors (BDBR) decided to begin normalizing monetary policy in its meeting in September 2021. In its September and October meetings the BDBR decided by majority to increase the monetary policy rate by 25 and 50 basis points, respectively, to 2.5% (Graph 1.5).