

## DEVELOPMENTS IN INFLATION AND MONETARY POLICY DECISIONS

The various indicators of economic activity in the fourth quarter of 2014 reflect vigorous domestic demand. Retail sales performance, consumer lending and consumer confidence suggest household spending accelerated during that period. There appears to have been important growth in investment as well, both in civil works and in machinery and equipment, and transportation equipment. It is estimated that the contribution from net exports was negative, due to a slowdown in exports. Given this information, the technical staff at *Banco de la República* is forecasting around 4.0% growth in the fourth quarter of 2014 and nearly 4.1% in the second half of the year. While this would imply less momentum than during the first six months of 2014, the country's economic performance continues to be remarkable for the region. GDP growth in 2014 would have been between 4.5% and 5.0%, with 4.8% being the most likely figure.

Oil prices on the international market plunged as of the third quarter of 2014, particularly during the last three months of the year. In fact, by December, the price of oil was 50% below the levels witnessed at mid-year. The net impact of this decline on global economic growth is likely to be positive, but mixed. Oil importing countries will benefit, thanks to household budget relief, lower input costs, and an improvement in their external position. However, oil exporting countries will be affected by a drop in their revenue and the pressure this would exert on their public finances and external balances.

In Colombia, the impact of lower oil is negative, since 55% of the value of the country's exports in dollars pertains to oil. The effect of this shock passes through to the economy via different channels. The most important one is deterioration in the country's terms of trade. This is reflected in a drop in national income and investment, as well as deterioration in Colombia's trade balance. Lower prices also reduce capital inflows, especially for foreign direct investment, a third of which went to the oil sector during the

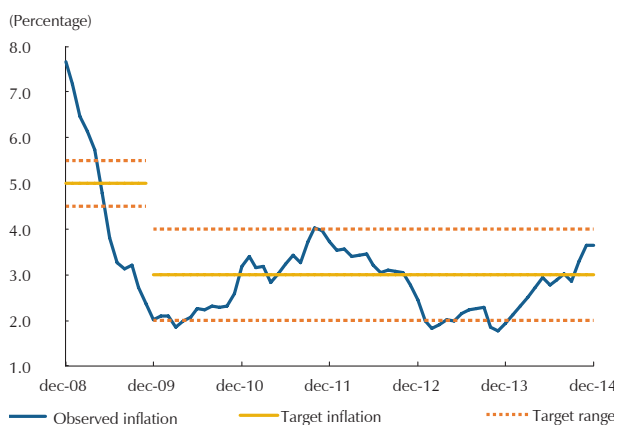
first three quarters 2014. Moreover, lower oil prices weaken the fiscal balance, as nearly 20% of all national government revenue comes from the oil industry, which also is the main source of royalty income for the regions.

Nevertheless, it is expected that other economic variables will cushion the effects of the oil shock. For example, the anticipated increase in investment in civil works and public consumption should mitigate the slowdown in economic activity. Likewise, depreciation of the Colombian peso against the dollar makes exports more competitive, as is also the case with production in certain sectors that compete with imported goods. This, in turn, will generate more demand for goods produced in the country, as the prices of similar imported goods would tend to become more expensive than those produced domestically.

The drop in oil prices has occurred in a context of weak and uneven global growth. While the United States economy continued to recover and gain strength, expansion in the euro area and Japan remains weak. The emerging countries are growing at a slower pace or at historically low rates. Therefore, the average growth of our trading partners in 2015 might be a bit higher than 2014, but still less than what was estimated in recent months.

Considering all these elements, the technical staff at *Banco de la República* lowered its growth forecasts for the Colombian economy in 2015 to between 2.0% and 4.0%, with 3.6% being the most likely figure, as opposed to the earlier forecast of 4.3%. The negative impact of the plunge in oil prices on national income is beginning to be evident in the investment budget cuts being made by the oil companies that operate in Colombia.

Graph A  
Total Consumer Inflation



Sources: DANE and Banco de la República.

As for prices, inflation continued to climb during the fourth quarter and was 3.66% by December, which is within the target range set for 2014 by the Board of Directors of *Banco de la República* (Graph A). The deviation from the central point is explained largely by reversal of the temporary declines in food and regulated goods prices, and by temporary increases in other items prices, such as entertainment, cultural activities and recreation. The peso depreciation associated with the sharp drop in oil prices that occurred in the second half of the year has yet to be reflected in consumer prices.

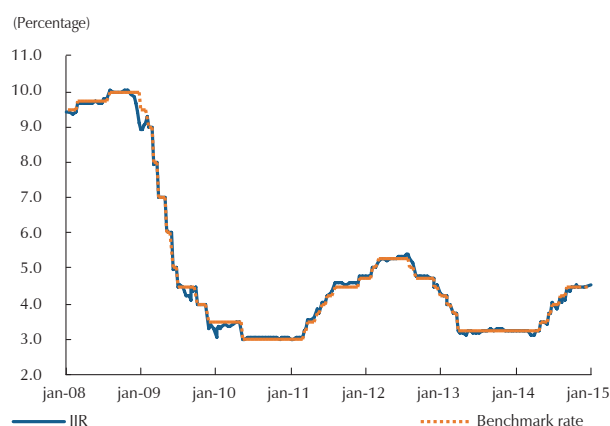
The rise in consumer inflation sparked an increase in core inflation and inflation expectations, but on

a lesser scale. Expectations in early January were in the upper half of the target range.

According to the technical staff estimates, during the first half of 2015 inflation will be at levels similar to those on record at the end of last year. The effects of peso depreciation are felt primarily in prices for tradable goods. However, since the decline in prices for oil and other raw materials is likely to prompt cutbacks in production and transport costs, and aggregate demand will not exceed the economy’s productive capacity, higher

prices for tradables will not jeopardize the target range defined for inflation this year. Inflation will likely begin to converge towards 3.0% during the second half of 2015.

Graph B  
Banco de la República’s Benchmark Interest Rate and the Interbank Interest Rate (IIR)  
(2007-2014)<sup>a/</sup>



a/ The figures match the data for business days; the last figure is for October 10, 2014.  
Sources: Office of the Colombian Superintendent of Finance and Banco de la República

In conclusion, domestic demand remains vigorous in a context nearing full productive capacity utilization. Meanwhile, inflation and inflation expectations have increased and are within the upper half of the target range. This occurs at a time when terms of trade are deteriorating and there is uncertainty about how they will evolve in the future and its impact on aggregate demand. As a result, after carefully analyzing the risk balance, the Board of Directors of *Banco de la República* decided, at its meetings in November and December 2014 and in January 2015, that it was appropriate to hold the benchmark interest rate at 4.5% (Graph B).

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