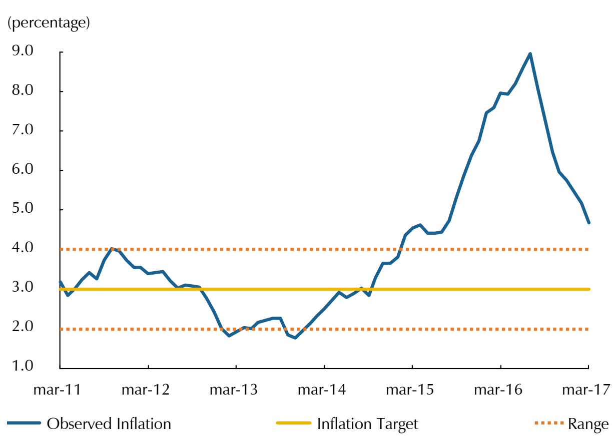
Inflation Developments and Monetary Policy Decisions

In March 2017, annual consumer inflation fell for the eighth consecutive month, standing at 4.7% (Graph A). The slower pace of the increase in food continued explaining the overall slowdown in consumer prices. Non-food CPI (5.1%) and the average of the four core inflation indicators (5.5%), which exclude the prices that respond to supply shocks, or which are highly volatile, returned to a slow descent in their annual variations, although at rates exceeding the 3.0% target and similar to those observed last December.

Several factors could explain the slow decline in core inflation. One of them, transitory in its nature, was the increase of VAT and other indirect taxes, whose impact on the level of prices would have taken place, for the most part, in the first months of 2017. The group of tradable goods excluding food and regulated items would have been the most impacted by this fact, which would explain its acceleration, to a great extent. The price of gasoline, also affected by the tax reform, registered high increases, and prevented further declines in the annual variation of regulated items.

Indexation of wages and prices has increased the persistence of inflation, a factor that has also contributed to slow down the reduction of the annual variation in consumer prices. This effect has been reflected with greater intensity on the group of non-tradable goods, whose annual variation accelerated in the first three months of the year. In fact, labor-intensive sectors such as education and health services, which were not included in the tax reform, have registered significant increases in prices, similar to those in the minimum wage and the general level of wages. Indexation is also affecting the price variation in leases, which have exhibited a slow but steady increase so far this year.

Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República.

The lower annual variation of the CPI and monetary policy actions have contributed to reduce inflation expectations, some of which are already within the Central Bank´s range (3.0% ± 1 pp). Particularly, inflation expectations embedded in public debt bonds suggest that average inflation in 2018 would post at 3.18%, and close to 3.0% for longer maturities.

Regarding economic growth, the Colombian economy is culminating the adjustment process of domestic demand, as a response to the deterioration of national income since mid 2014. Facing this deterioration, mainly reflected on a fall in public revenue, the tax reform was necessary in order to achieve an orderly adjustment of the economy, ensure fiscal and external sustainability of the country, and, in general, to strive for investment and sustainable economic growth. However, in the short term, the increase of the VAT and other indirect taxes has affected the spending capacity of households, and therefore consumption. The lower purchasing power of households due to the increase in inflation and the monetary policy actions necessary to return inflation to its 3.0% target have also contributed to a lower economic growth. Additionally, although external demand has recovered slightly, its expansion is still low and has been insufficient to promote robust exports by the country.

Within this macroeconomic context, the figures of economic activity for the first quarter of 2017 suggest that the dynamics of domestic demand would have been weaker than expected three months ago. In fact, the consumer confidence index and retail sales suggest that consumption is growing at historically low rates. Investment could register a modest recovery, mainly due to civil works. Net exports would have subtracted from growth. With these figures, the technical staff at *Banco de la República* estimates an economic growth figure of 1.5% for the first quarter of 2017, within a range between 0.8% and 1.8%.

For the remainder of 2017, a low increase in output is expected, exhibiting a modest recovery in the second half of the year. The behavior of domestic demand would continue to be weak, led by investment in civil works. External demand and the country's terms of trade are likely to continue recovering within a more dynamic environment —although highly uncertain— for world trade. With all this in mind, the technical staff revised its forecast of the most likely growth figure for 2017 from 2.0% to 1.8%, within a range between 0.8% and 2.6%.

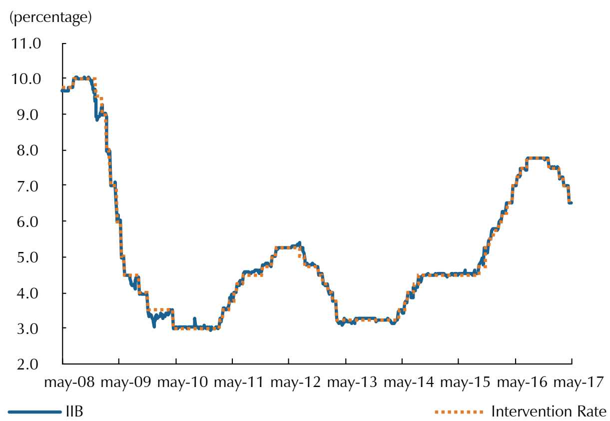
In all, the Colombian economy continues to adjust to the strong shocks recorded since 2014, and it is likely that the current account deficit will continue adjusting. The dynamics of output has been weaker than forecast; also, there is a higher risk of a slowdown that is stronger than what is compatible with the adjustment to the deterioration in national income. Inflation continues to decline, but this is due, above all, to the prices of food. The reversal of core inflation has been slower than that of headline inflation, as the former has been affected by the increases in taxes, indexation mechanisms, and by the increase of the persistence of inflation.

Facing this macroeconomic situation, the Board of Directors of the Central Bank considered the following issues in its most recent decisions:

- The increasing weakness of economic activity and the risk of a greater-than-anticipated slowdown.

- Uncertainty about the speed of convergence of inflation to its 3.0% target: the reduction of inflation is explained mainly by food prices. Indexation mechanisms and the increase in the persistence of inflation may delay convergence of inflation to the target.

Graph B
Banco de la República's Intervention Rate and the Overnight Rate (OR)
(2009-2016)[a/]



a/ The figures correspond to data from working days; the last figure corresponds to 19 May 2017.
Sources: Superintendencia Financiera de Colombia and Banco de la República.

- The current level of the real policy interest rate continues to be contractionary.

- This rate is measured taking into account inflation expectations, which have been reducing.

Analyzing the above, in each one of its meetings of February and March this year the Board decided to reduce the benchmark interest rate by 25 bp, and by 50 bp in April. In this last meeting, the Board considered that 6.5% was a level consistent with the risk balance as well as with the purpose of reaching the 3.0% inflation target in 2018 (Graph B). Additional reductions would consider the risk balance between a slow convergence of inflation to 3.0%, and a greater slowdown of economic activity versus the forecast.

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