01/Executive Summary

#MuseoEnTuCasa is an activity summoned by the Art and Collections Unit on Instagram @banrepcultural.

Here, the Rodríguez-Tobón family enacts the work titled La Familia (“The Family”), by Colombian artist Fernando Botero, which makes part of *Banco de la República*’s art collection.

Photo credits:
Left: Botero Museum, Banco de la República.
Right: Irene Tobón Restrepo.

Introduction

After a year, the Covid-19 pandemic continues to cause serious damage to the economy and society, affecting the low-income levels most severely. In fact, part of the progress in reducing poverty that the country had achieved in the last two decades has been lost. The governments and central banks around the world, including Colombia, have made funds available to ensure that the productive apparatus continues to work, and the social costs of the crisis are mitigated. Likewise, science has employed all its research capacity. These efforts have prevented an even greater collapse and are beginning to bear fruit. During the second half of 2020, global economic activity showed signs of recovery and unemployment began to decline. Public policies in support of companies helped preserve the business fabric, although many of them closed or went bankrupt. Moreover, in less than a year, effective and safe vaccines have been developed and with them, the vaccination process is advancing in many countries, including Colombia. All of this lays the groundwork for an economic and social recovery that, unfortunately, will probably have ups and downs and could take several years. It will certainly require active international cooperation and economic reforms to restore macroeconomic balances and long-term growth. The humanitarian trauma left by this pandemic will last for a long time and will require the support of the entire society.

Just two years prior to its 100th anniversary, *Banco de la República* (the Central Bank of Colombia) faced the greatest challenge in its history with the Covid-19 pandemic. While the various crises of the past three decades – including the global financial crisis of 2008 and the one triggered by the oil price collapse in 2014 – were difficult and costly, their origins were entirely economic. This made them more predictable and to some degree easier to mitigate. In contrast with the above, the current crisis is not only more intense with respect to its effects on growth and employment but in origin, it is health-related rather than economic. The latter makes it unpredictable with respect to its intensity and duration, and this makes it difficult to handle. The measures taken by *Banco de la República* and the government have sought to mitigate the economic effects of the pandemic but do not constitute a solution to the source of the problem which is eminently health related. On the contrary, the health measures taken to deal with the pandemic have evidently accentuated the short- and medium-term recessionary effect as occurred in Colombia during the first year of the pandemic even though they will have a beneficial economic effect in the long term.

From the very beginning of the pandemic, the Board of Directors of *Banco de la República* (BDBR) understood the exceptional nature of the crisis that was beginning and the danger that it meant for the country's economic stability. That is why the Board did not hesitate to act quickly and decisively even amid the great uncertainty and volatility caused by the arrival of the virus in Colombia. The BDBR knew that the financial sector had the strength to deal with a shock of that magnitude due to the adoption of macroprudential measures in recent years and the strict supervision of the financial entities that has been done in compliance with international standards like those of Basel III. This enabled the BDBR to concentrate their efforts on three basic objectives: 1) protect the payment system; 2) stabilize key markets such as foreign exchange and public and private debt securities that have been subjected to intense pressure; and 3) the creation of the conditions needed for credit to continue to flow into the economy.

In line with these objectives, the BDBR undertook the necessary actions to give the market ample liquidity in pesos in order to provide financial intermediaries with enough funding to maintain a suitable supply of credit for households and businesses. This injection of liquidity also helped stabilize public and private debt markets and ensure the smooth functioning of the payment system. To reduce pressure on the foreign exchange market, in turn, intervention mechanisms were introduced that facilitated hedging and expanded liquidity in dollars without affecting the amount in the foreign reserves. At the same time, the BDBR started to progressively cut the policy interest rate and took it from a starting level of 4.25% in March 2020 to one of 1.75% in September, its lowest historical nominal level, which is equivalent to a real interest rate (*ex ante*) of -1.0% when inflation expectations for 2021 are discounted. The precise set of measures that the BDBR adopted to meet the goals described are discussed later in this summary and explained in detail in section 2.2 of this report.

A year after the pandemic started, it is possible to confirm that the decisions made at the time by the BDBR contributed to maintaining the normal functioning of the financial markets. The supply of credit continued to flow into the economy and alleviated the initial pressure on the public and private debt markets. The foreign exchange market also stabilized largely due to the transactions carried out by *Banco de la República* and the confidence of the agents in the support offered by the appropriate level of foreign reserves. The pronounced growth of the monetary aggregates (base and M3) reflected the greater preference for liquidity which was served in a timely manner by *Banco de la República*. As can be seen in Box 1 in this report, the reductions in the policy interest rate were rapidly transmitted to the financial system's interest rates on deposits and lending rates. This contributed to restore the volume of credit disbursements which, at the end of 2020, were similar to those registered before the pandemic. These lower interest rates will continue to drive the economy's recovery in 2021.

Going forward, the ability of *Banco de la República*'s monetary policy to support the recovery of economic activity and employment depends to a large degree on developments on the foreign and fiscal fronts. Specifically, the combination of an environment of sufficient liquidity and low financing needs supports macroeconomic stability, facilitates monetary policy management, and allows for its effects to be transmitted more efficiently.

The greater need for public spending to address the consequences of the pandemic and the lower tax revenue caused by the slowdown in economic activity has deteriorated fiscal positions worldwide. In the case of Colombia, public debt rose substantially in 2020 and has acquired a momentum that, if not reversed, will jeopardize the country's ability to meet it. This reality is a threat to the public sector's access to both local and foreign financing at a time when this access is indispensable for the normal implementation of the national budget.

Thus, the ability of the Bank to continue to support the recovery is closely associated with the approval of the fiscal adjustment program that the government will soon put before Congress.

This report is divided into five parts. After this first section containing the executive summary, the second will proceed with a detailed discussion of the macroeconomic environment and *Banco de la República*'s decisions in view of the Covid-19 crisis. There the effects of the health shock on Colombia are explained and the logic and characteristics of the measures taken by the BDBR to deal with the economic effects of the pandemic are delved into. The international macroeconomic environment is also discussed and the change in the country's main macroeconomic variables such as the financial markets, economic activity and the labor market, the balance of payments, and inflation are described. The rest of the report concentrates on issues inherent to the management of *Banco de la República*. The first of these, related to the management of the foreign reserves, their composition, profitability, and the measures adopted to increase the country's international liquidity are analyzed in the third section. *Banco de la República*'s financial statement is presented in the fourth section. A report on *Banco de* *la República's* cultural management, which the BDBR considers very important, is included in the fifth section. Furthermore, this report includes shaded sections and boxes that address topics that must be presented separately due to their technical content. Among them, Box 1 on the transmission of the monetary policy interest rate to the market interest rates and Box 2 on the flexible credit line (FCL) with the International Monetary Fund (IMF) stand out.

1.1. The International Economic Shock

The rapid expansion of Covid-19 from China to Europe, Asia, and the United States during February 2020 together with the subsequent social distancing measures that began to be introduced in various countries alarmed the international markets. The main stock markets around the world saw sudden drops. The risk indicators deteriorated and the prices of oil and other raw materials plummeted. The extension of the lockdown around the world led to a sharp reduction in international trade in goods and services, and an effect on global value chains. The figures on economic activity for the second quarter of the year that were released later in the year showed the magnitude of the initial impact of the pandemic on the global economy. The economy of the United States contracted -9.0% and in the Euro zone, it contracted -14.7%. The main economies in the Latin American region registered significant declines in the Gross Domestic Product (GDP) during the same period, thus: Peru, -30%; Mexico, -18.6%; Chile, -14%; Brazil, -10.9%; and Colombia, -15.6%.

Central banks around the world reacted strongly to the first signs of economic deterioration caused by the pandemic through significant interest-rate cuts and strong injections of liquidity. Towards mid-July, this massive response had partially reversed the initial deterioration in financial conditions. The stock markets stopped declining and showed significant recoveries in several countries. The risk premia were corrected, and the volatility indices of the international financial markets showed substantial improvements. These measures, together with fiscal policy responses and the relaxing of the lockdowns in some countries helped to reassure the markets and laid the groundwork for the start of a recovery.

In the third quarter of 2020, global output registered a positive change in its trend from the steep decline that occurred in the second quarter. The fiscal and monetary policy responses and the relaxation of lockdown measures stimulated aggregate demand and economic activity, and this was also reflected in increased world trade. Nevertheless, towards the end of the year, this rebound lost strength, especially in Europe, due to the need to impose new lockdowns to contain another outbreak of the virus and appearance of new strains.

In this context, the IMF estimates that the global economy contracted 3.5% in 2020 while the advanced economies fell 4.9% and the emerging and developing economies fell at a more moderate rate of 2.4% due to the 2.3% growth of the Chinese economy. The IMF has estimated a 7.4% reduction for Latin America and the Caribbean in 2020. This is the sharpest decline among all the groups of countries considered. The World Bank, in turn, estimates that the contraction in global output in 2020 was 4.3%, which is higher than what the IMF considered, and the drop in Latin America and the Caribbean was 6.9%. Last of all, for Colombia's trading partners, the technical staff at the Bank has calculated a drop of close to 7.0% which is more accentuated than what occurred in the world economy. This is explained by the sharp reduction in the GDP of important trading partners such as Peru (-11.2%), Mexico (-8.5%), Ecuador (-8%), and the euro area (-6.8%).

Since the collapse of economic activity caused by the Covid-19 pandemic, all forecasts point to a significant recovery in 2021 and 2022 although this is subject to a high degree of uncertainty. For example, in their January review, the IMF projected 5.5% growth in the global economy in 2021 and 4.2% in 2022. This forecast considers the stimulus to global economic activity that could be generated by progress in vaccination and the support policies announced in large economies. Favored by supply and demand conditions, in turn, the price of crude oil has reached pre-Covid levels and exceeded the expectations of the markets, analysts, and international organizations. Based on the above, the World Bank and the Organization for Economic Cooperation and Development (OECD) agree with the IMF in anticipating a return to world growth of about 4.0% in 2021 and 3.8% in 2022.

The pace of recovery may vary between countries depending on factors such as vaccination coverage, the scope of support policies, and the structural characteristics of the countries when they entered the crisis. The IMF forecasts growth of 4.1% for Latin America and the Caribbean in 2021 and 2.9% in 2022, and for Colombia, it forecasts 4.6% in 2021 and 3.7% in 2022. The World Bank's forecasts for the region are similar as they predict a growth of 3.7% in 2021 and 2.8% in 2022.

The uncertainty surrounding these forecasts is significant. On the positive side, success in the vaccination process which would require accelerating vaccination production and improving its distribution would increase expectations of a rapid end to the pandemic and boost confidence in business owners and consumers and thereby boost final demand, income, and employment. However, less than anticipated growth could occur if the spread of the virus is not contained due to the inability to ensure mass access to the vaccine and the emergence of new strains that require lockdowns or other restrictions. The prolonged economic weakening could accelerate business failures, especially if government support is prematurely withdrawn. Financial conditions could become more restrictive for countries that are highly indebted and social tensions could be exacerbated by high unemployment and greater inequality. All of that could affect the expectations of a rapid end to the crisis and decimate the confidence of the economic agents.

1.2 The Shock to the Colombian Economy and *Banco de la República's* Measures

In Colombia, just as in many countries, the Covid-19 pandemic resulted in an unprecedented drop of economic activity due to the lockdowns, quarantines, and other restrictions on mobility that were indispensable to containing the progress of the disease. Added to this was the very fear of contagion that induced many people to stop interacting and thus interrupted their economic and social activities. The sharp fall in mobility caused by both the restrictions imposed and the preventive behavior of the population produced two simultaneous phenomena. First, a collapse in domestic demand resulting from the sharp contraction in household consumption and investment and, second, a decline in supply, mainly for those productive sectors that require close social interaction. Added to this was a sharp decline in terms of trade due to the drop in oil and coal prices both of which are an important part of our export basket. This precipitated the fall in the country's exports which had already been affected by the collapse of world demand. These shocks tended to reinforce each other as they brought about a fall in national income, an increase in unemployment, and the deterioration of consumer and business confidence.

It was thus that the shock of the pandemic initially produced a widespread paralysis of economic activity that the country had never before experienced. Unlike natural disasters that paralyze a region but have a very limited effect at the national level, what began to happen with this emergency was an unusual phenomenon that jeopardized the country's economic stability and required an immediate and forceful response from both the national government and *Banco de la República*.

And thus, it was that the BDBR began to act even before the first case of coronavirus was confirmed in Colombia. The BDBR counted on the financial system's soundness and, on that base, they decided to draw up the above-mentioned specific objectives that were essential for the operation of the country's economic system in the short and medium term. The precise nature of the objectives that were set favored the effectiveness of the measures adopted as could be demonstrated later. Succinctly, *Banco de la República*'s response included the following set of measures which will be discussed extensively in Section 2.2 of this report. 1) extension of the eligible amounts, counterparties, terms, and securities of the Bank's transitory expansion operations (repos). To this end, access to liquidity resources was given to a larger number of entities and the use of private debt securities and securities from portfolio operations in addition to the usual public debt securities as collateral was authorized. 2) permanent liquidity was injected into the economy through the definitive purchases of public debt securities and securities issued by credit institutions. These transactions were designed to provide liquidity for prolonged periods and reduce the uncertainty of the financial intermediaries about their funding. 3) the average reserve requirements were lowered from 7.0% to 5.0% in order to permanently free up resources for the economy and to strengthen the incentives for financial intermediation by reducing its costs. 4) modern mechanisms of intervention were used on the foreign exchange market to facilitate hedging and expand liquidity in dollars without affecting the amount in the foreign reserves.[1] 5) the policy interest rate was reduced 250 basis points (bp) from an initial level of 4.25% in February to 1.75% in September 2020 and thus placing it at a historic low. 6) international liquidity was increased through the direct purchase of foreign currency from the national government, the renewal and expansion of the flexible credit line with the IMF, and access to the Repos Facility (FIMA) offered by the Federal Reserve.

1.3 Economic Activity

As was noted, the social distancing measures to control the spread of the virus that were implemented in the country starting the last ten days of March 2020 and people's fear of becoming infected caused a sudden halt to economic activity which had been normal until then. Thus, the growth of the GDP for the first quarter was 0.1%, although during January and February economic performance had been satisfactory with an annual growth of 3.7% and 3.0% respectively according to the economic monitoring index (EMI, ISE by its acronym in Spanish) published by DANE (seasonally adjusted and corrected for calendar effects, sace).

But it was in the second quarter that the collapse of the economy became apparent with an annual -15.6% contraction of the GDP.[2] With this result, the growth in the first half of the year stood at -7.8%. Other economies in the region and some OECD countries suffered similar contractions during this period, and this showed the severity of the economic shock that the Covid-19 pandemic was beginning to cause.

During the third quarter of 2020, there was an improvement in the Colombian economy's performance. This was made possible by the relaxing of the restrictions on mobility and the first effects of the measures taken by the government and *Banco de la República* to deal with the crisis. Thus, after bottoming out in

---

1 These mechanisms were: 1) forward sales of dollars with financial compliance at one month to extend coverage against the risk of a sharp depreciation of the peso, and 2) dollar swaps at two-months to stabilize the foreign exchange market and provide liquidity in dollars. How they work is explained in the body of the report.

2 Calculated for the sace series.

the second quarter, DANE reported that the contraction of the GDP during the third quarter had been reduced to -8.3% per year which was equivalent to an annualized quarterly change of 43.1% for the sace series. This result showed that even amid the pandemic, economic activity was beginning to show signs of recovery. The trend towards recovery seen in the third quarter continued into the last quarter of the year when the annual contraction of output dropped to -3.5%. This is equivalent to an annualized quarterly change of 26.5%. Therefore, during the second half of 2020, the change in the GDP compared to the same period in 2019 was -5.9%, a smaller decline than had been registered in the first half of the year. This showed evidence of a significant reversal of the cluster of negative economic effects from the beginning of the pandemic.

The pattern of economic activity in Colombia shows a V-shaped trend throughout 2020 and is similar to that of many other countries. This means that the economy suffered a dramatic decline during the first months of the pandemic followed by a marked recovery although statistics show that it still has not reached the pre-pandemic level. The main question is whether the recovery will continue, or will new outbreaks occur like the one that happened this January which could determine a W-shaped economic pattern during 2021. This risk introduces a high degree of uncertainty about the performance of the Colombian economy this year. That is why the 4.5% growth forecast for 2021 prepared by the technical staff is framed within a relatively wide range: from 2.0% to 6.0%. For this forecast, the effects of the more restrictive social distancing measures required in January and part of February were taken into account, but new significant outbreaks of the disease for the remainder of the year were not considered. In addition, it is assumed that Covid-19 vaccination targets proposed by the national government are met.

In mid-February 2021, DANE reported that Colombia's GDP had fallen 6.8% in 2020. This decline was slightly less than what the technical staff at *Banco de la República* and the IMF had anticipated (-7.2% and -7.9% respectively). Even so, it is the largest recession registered for the Colombian economy in modern times. Moreover, this contraction is lower than the one estimated by the IMF for Latin America and the Caribbean in 2020 (-7.4%) but is more pronounced than the one that occurred in the world economy (-3.5%) and to the OECD countries (-4.9%).

On the demand side, the contraction of the GDP in 2020 resulted from a collapse in household consumption that could not be offset by government consumption due to which total consumption was down -4.1%. Added to this was a sharp contraction in gross capital formation (-21.2%) induced by the decline in its main components such as housing, other buildings and structures, and machinery and equipment. Thus, domestic demand, which is the total of consumption and investment, contracted -7.6% in 2020. The effect of the decrease in domestic demand on the GDP was partially offset by an improvement in net foreign demand since the drop in imports was sharper than what was registered for exports.

From the point of view of the branches of production, the sectors with the largest contractions in 2020 were construction (both buildings and public works), mining and quarrying, commerce, repairs, transportation, and housing, and artistic and recreational activities. In contrast, the agricultural sector, financial activities, real estate activities, and public administration, education, and health grew in 2020.

1.4 Employment

The contraction of the gross domestic product in Colombia in 2020 came mainly from those branches that are labor-intensive, such as construction, commerce, manufacturing, and arts and recreation which translated into a historic increase in the unemployment rate, both nationally and in the country's thirteen main urban areas.

The most critical moment for the labor market occurred in April when about a quarter of the jobs existing before the crisis were lost. As a result, the unemployment rate (UR) that month reported by DANE came to 19.9% for the national total and to 23.8% for the thirteen cities and was approximately double the corresponding levels of unemployment seen in April 2019 (10.3% and 11.1% respectively).

As the social distancing measures began to relax, new jobs were created at a faster pace than the growth in labor participation. This was reflected in successive decreases in unemployment during the second half of the year that led, in December, to the UR standing at 14.3% nationwide and at 16.4% for the thirteen major cities, based on DANE's seasonally adjusted monthly series. The number of employed people in December indicated that close to 77% of the jobs lost in the country between March and April had been recovered by the end of the year (4.7 million jobs). Even so, the number of people employed continued to be 1.4 million lower than in the pre-pandemic period. In the case of the thirteen major cities, about 70% (2.3 million) of the jobs lost between March and April had been recovered by the end of the year. Nevertheless, this recovery was not uniform across population groups and types of employment, which accentuated gender disparities and introduced changes in the composition of employment.

With respect to change by population groups, the seasonally adjusted series shows that the recovery in employment for women was slower than for men. Due to that, between June and December, the unemployment rate for women declined 5.1 pp while the rate for men decreased 6.1 pp. This led to historically high levels on unemployment gender gap, which was associated with unemployment rates for women and men of 20.0% and 11.3% respectively at the end of 2020. Another effect of the crisis was the greater reduction in women's participation in the labor force (OPR) due, in part, to the closure of children's daycare and schools which prevented many women with children at home from working.[3]

In terms of the change by types of jobs, in the second half of 2020, the growth of employment was stronger in the non-wage and informal segments. For the twenty-three major cities, in the quarterly moving average that ended in December, salaried employment grew 13.6% (700,000 jobs) and non-salaried, 26.9% (1.1 million jobs) with respect to the quarterly moving average ending in June. This growth suggested that between May and December close to 75% (1.3 million) of non-salaried urban jobs that had been lost between March and April were recovered compared to 55% (1.0 million) in the salaried segment. The change in the breakdown of employment is also seen when distinguishing between formal and informal employment. These have recovered about 56% (800,000 jobs) and 70% (1.5 million jobs) respectively of the jobs lost in the wake of the pandemic. This phenomenon is explained by non-wage employment and the sectors with the most informality are characterized by being the most affected segments of the labor market when the economy falls but also the most flexible when a recovery starts.

Estimates by the technical staff suggest that national UR will probably continue to decline in 2021 but at a slower pace than was seen in the second half of 2020 given the slow recovery of salaried and formal employment as well as the level of the GDP that remains below the level in 2019. Thus, the average national UR for

3 For a detailed analysis see: "Recuperación de la ocupación y dinámica reciente de la participación laboral," Grupo de Análisis del Mercado Laboral (Gamla), at *Banco de la República*, January 2021, available at: https://repositorio.banrep.gov.co/handle/20.500.12134/9976

all of 2021 is likely to be between 12.5% and 15.5% with the most probable value being around 14.0%.

1.5 Inflation and Policy Framework

Last year the inflation targeting regime with flexible exchange rate under which monetary policy decisions are made completed two decades of operation in Colombia. The adoption of this regime at the end of 1999 made a progressive decline in annual inflation to the long-term target of 3.0% possible. This was achieved in 2009 and has been in force since then. Over the last decade, the inflation rate has remained around that level except for temporary deviations usually caused by shocks to food prices. Monetary policy management has been consistent with achieving the inflation target and with output growth around the potential capacity of the economy. This has made it possible to anchor inflation expectations around the 3.0% target and carry out a counter-cyclical monetary policy that has contributed to the country's macroeconomic stability. The flexibility of the exchange rate as a basic element of the inflation targeting plan has been essential to achieving the economic adjustments required in the wake of the external shocks that the Colombian economy has received during the last few years.

This institutional framework has been the basis for monetary policy management in the wake of the severe economic consequences of Covid-19. The pandemic caused simultaneous negative supply and demand shocks to the economy. With respect to supply, the social distancing measures that forced many establishments to be closed and their workers remain in lockdown compelled various branches of the economy to reduce or stop their productive activity. On the demand side, household consumption plummeted not only because it was impossible for people to go out and consume but also due to the drop in their incomes and loss of confidence. This was compounded by a sharp contraction in gross capital formation. If the phenomenon had been limited to only a contraction in supply, it would have caused a rise in inflation and a decline in output. But what was seen was a decline in inflation (which went from 3.8% in 2019 to 1.61% in 2020) and a reduction of the GDP (-6.8%). This made it possible to deduce that, in 2020, the negative demand shock dominated the negative supply shock.

The inflation rate stood below the inflation target in 2020 (1.61% vs. 3.0%), and economic growth (-6.8%) was well below the potential growth which is estimated to have an annual rate of 3.0%. The forecasts made by the technical staff anticipated these results with the first signs of the impact of the pandemic. This allowed BDBR to take timely action. Following the monetary policy rule embedded in the inflation targeting plan, the BDBR started a progressive cut in the policy rate as of March 2020 which took it from a starting level of 4.25% to one of 1.75% in September 2020 where it remained the rest of the year. In addition, the Bank was able to implement an important set of policies to ensure an abundant supply of liquidity for the public and private financial markets in both pesos and dollars.

The reduction in the rate of inflation reflected the economic consequences of the health crisis. In particular, the downward pressure that dominated the trajectory of inflation was the fall in aggregate demand, the excess productive capacity, the low pass through of peso depreciation to prices and the effect of temporary tax and tariff relief. This downward pressure outweighed the upward price effects due to supply restrictions resulting from the close down of various economic sectors. After reaching an annual peak of 3.86% in March 2020, inflation began to decline starting in April. This downward trend continued until November when it hit a minimum annual rate of 1.49%. After a rebound in December, inflation closed the year at 1.61%, the lowest level for a year-end since the existence of records. This fall of more than 50% from the initial level in just nine months facilitated the decision to move ahead on a significant easing of monetary policy through a substantial cut in the policy interest rate and the abundant injection of liquidity that *Banco de la República* started to make during the first few weeks of the pandemic.

Core inflation also showed a considerable decline. Thus, for example, the measurement of inflation excluding food and regulated items closed the year at 1.11% having fallen 200 bp with respect to December 2019. The other two indicators of core Inflation also registered significant declines such that, at the end of 2020, the average for the indicators of core inflation stood at 1.34% compared to the 3.44% level in 2019. The overall decline in core inflation reflected the sharp weakening of aggregate demand.

The persistence of large excess productive capacity in 2021 and price indexing at low rates should keep consumer inflation below the 3.0% target though with a slow trend toward its convergence. Inflation expectations point in this direction with an expected value for December of 2.74%.[4] The trend of annual inflation to return to the target should begin to take place as of the second quarter to the extent that the economy recovers, and the price relief decreed in 2020 is withdrawn. Likewise, the low base for statistical comparison from last year caused by the sharp decline in inflation makes it likely that a rise between the second and fourth quarters of this year will be seen. As with other macroeconomic variables, this forecast is subject to high uncertainty given the risks posed by changes in the pandemic and the challenges in measuring the inflation resulting from it. Under these circumstances, the technical staff at the Bank estimates that headline inflation will stand below the 3.0% target by the end of 2021.

1.6 Balance of Payments

At the end of 2020, the country's balance of payments current account registered a deficit of USD 9,083 million (m) which is USD 5,201 m lower than what was seen in 2019. This meant that the deficit in the current account went from 4.4% in 2019 to 3.3% of the GDP in 2020. This decrease could seem paradoxical given that it occurred amid a sharp collapse in foreign demand resulting from the 3.5% contraction in global output in 2020 (according to the IMF) and the -7.1% contraction in the economies of our trading partners. This outcome looks even more unexpected given the sharp declines in international crude oil prices and prices for other raw materials exported by our country, especially at the beginning of the pandemic. Under these conditions, understanding what led to the reduction of the country's deficit in the current account during such an atypical period as 2020 is of special interest.

The primary reason for the reduction of the current account deficit during the previous year was the USD 4,728 m decrease in the deficit balance of primary income. This was mainly explained by lower outflows of profits linked to foreign direct investment (FDI). The decline in FDI profits was widespread across all economic sectors but especially notable for oil drilling companies, financial and business services, transportation and communications, manufacturing industry, and mining and quarrying. This result shows the beneficial counter-cyclical role that companies with foreign capital play in stabilizing the country's external balance in the wake of major negative shocks like the one we face.

A second reason behind the reduction of the deficit in the current account was the decline in imports which allowed for a USD 532 m fall in the trade deficit in goods even though the value of exports fell USD 8,886 m. Indeed, the fall in the

4 Corresponds to the median of the Monthly Survey of Economic Analysts' Expectations for March 2021.

absolute value of imports was even greater (USD 9,419 m). The decline in exports arose mainly from the lower sales of oil and its derivatives, coal, industrial products, nickel-iron, and flowers. The drop in value of imports, in turn, reflects the contraction in the country's economy and it is mainly because of the decline in imports of supplies and capital goods for industry, the purchases of fuel and lubricants from abroad, consumer goods, and transportation equipment.

The third reason for the decrease in the current account deficit was the 0.2% (USD 20 m) improvement in the balance of net current transfers (secondary income). Although this improvement was small, it should be noted that net income from transfers is of significant value (USD 8,724 m) and among them the income from workers' remittances which came to USD 6,853 m in 2020 and had an 1.8% annual increase (USD 120 m) stood out. This income is equivalent to 2.5% of the annual GDP and 12.9% of the current income from the balance of payments. The growth of remittances was because the amounts sent from the United States offset the declines received from Latin America and Spain.

The deficit in the current account for 2020 was financed from net capital inflows of USD 8,092 m (3.0% of the annual GDP). These inflows were the result of USD 23,492 m in foreign capital income that were partly offset by outflows of Colombian capital abroad (USD 11,579 m). Income from foreign capital came mainly from the placement of public debt securities (bonds and TES), external borrowing by the public sector, and foreign direct investment (FDI) as described below.

First, FDI in Colombia was USD 7,690 m in 2020, figures 46.3% lower with respect to the year before. The drop in FDI was due to 50.5% in reductions in capital shares and 68% in reinvestment of earnings. As was argued, this performance reflects to a high degree diminished profits (or losses) of companies in the country with foreign capital who limited the reinvestment of profits as a source of FDI.

On the other hand, capital inflows in the head of the public sector through both the placement of public debt securities and the contracting of loans from abroad came to a total of USD 18,448 m, which is an exceptionally high figure compared to the same inflows in 2019 (USD 727 m). This more-than-25-fold increase in foreign resources attracted by the public sector reflects the efforts of the national government, public entities, and territorial governments to obtain the financing to cover their budget shortages caused by income losses and higher spending requirements created by the Covid-19 emergency. Among those resources, the portion of the IMF's FCL (USD 5,400 m) that the national government disbursed in the last quarter of 2020 within the framework of the financial plan for the year, was notable.

Finally, the outflow of Colombian capital abroad to the tune of USD 11.579 b in 2020 was equally atypical if compared to the USD 376 m registered in 2019. Of this amount, the largest outflows came from private sector's portfolio investment and other items, contrasting with inflows on the same concept that were seen in 2019.

As a result of these capital movements, Colombia registered a net negative international investment position at the end of 2020 of USD 175,474 m (64.5% of the annual GDP). The negative position rose USD 5,937 m in comparison to what was seen at the end of 2019, which was consistent with the acquisition of higher external liabilities to finance the current account deficit.

The forecast of the technical staff points to a deepening of the current account deficit from -3.3% as a percentage of 2020's GDP to -3.6% in 2021, as a result of the gradual recovery of the Colombian economy despite the expected reversal of the external terms of trade shock and higher projected foreign demand. The expected rebound in domestic demand will probably induce growth in imports as well as growth in profits of companies in the country with foreign capital shares. Furthermore, the higher projected prices for some commodities will probably raise the earnings of the foreign-owned companies that export those products. These factors will probably be the main drivers of the expansion of the deficit throughout the year. Nevertheless, they will probably be partially offset by the effects of some higher terms of trade and the economic recovery of Colombia's trading partners that would make an increase in exports of commodities and industrial goods possible.

1.7 Foreign Reserves

At the end of 2020, net foreign reserves totaled USD 59,030.8 m with a USD 5,863.6 m increase compared to the outstanding amount in 2019. As explained in detail in Chapter 3 of this report, the accrual during the period was mainly explained by the purchase of USD 3,500 m and the return on the foreign reserves which, at the end of December 2020, was 3.37% (USD 1,888.89 m) excluding the foreign exchange component.

The purchases of foreign currency met the objective of strengthening international liquidity and were acquired directly from the national government which needed monetization of dollars from its portfolio for the treasury management in 2020. The profitability of the reserves, in turn, remained at a high level (3.37%) in 2020 due to the significant rise in bond prices held in the portfolio. This was the result of the Federal Reserve and other central banks reducing the interest rates to near-zero levels in order to deal with the economic effects of the pandemic. A scenario of high yields from the reserves was not foreseen at the beginning of 2020 since the international interest rates were expected to remain stable after the reductions seen in 2019. However, it is plausible to expect a considerable reduction in the profitability of foreign reserves in 2021 since there is no prospect of appreciations due to additional reductions in the rates given their proximity to zero.

To supplement external liquidity *Banco de la República*, in coordination with the Ministry of the Treasury, negotiated an extension of access to the FCL from the 384% of the country's quota in the organization (approximately USD 11,200 m) to 600% (approximately USD 17,600 m) of it with the executive Board of the IMF. Of this amount, last December the national government received an exceptional disbursement of 187.5% of the country's quota to the entity (around USD 5,400 m) as a supplement to the sources of foreign financing within the framework of the needs created by the pandemic. The remaining amount will continue to be precautionary. It should be recalled that the FCL is an IMF instrument that only countries with sound monetary, fiscal, and financial policy frameworks as well as a favorable record of economic performance can get access to. Colombia has had access to this line since its creation in 2009 (see Box 2 in this report).

The current level of the foreign reserves is largely satisfactory from the perspective of risk-hedging for the country's foreign liquidity. Indeed, this level covers the projected current account deficit of the balance of payments for the next twelve months plus the repayments on the external debt. Furthermore, the foreign reserves together with the IMF's FCL cover those needs for foreign financing and the risk of possible capital outflows.

Finally, in 2020, *Banco de la República* obtained access to the Federal Reserve repo facility (FIMA). Through this facility, FIMA account holders can exchange their U.S. Treasury bonds held in custody at the Federal Reserve for U.S. dollars with the commitment to repurchase the securities the next day and pay the interest. The primary benefit that access to the FIMA repo facility has for *Banco de la República* is to have liquidity in US dollars if needed without having to face adverse market conditions nor sell off the assets of the international reserve portfolios permanently. This access mitigates the liquidity risk.

1.8 *Banco de la República*'s Profits

Banco de la República's profits during 2020 reached an unexpectedly high value of COP 7,483 billions (b) (USD 1,888.89 m) that was higher than what was obtained in 2019 (COP 7,149 b; USD 2,322.76 m). This high an amount in profits was due to the extraordinary return on the foreign reserves invested in bonds abroad. These suffered a sharp price increase when the US Federal Reserve (FED) decided to reduce their interest rates to near-zero levels in order to deal with the economic effects of the pandemic. The magnitude of this surprise can be better appreciated if one recalls that at the beginning of 2020 when the FED interest rate was within a range of 1.5% to 1.75%, *Banco de la República* forecast a moderate return on the foreign reserves for this year of USD 585 m of which, USD 567 m would correspond to the portfolio of these reserves (USD 754 m for interest minus USD 187 m for devaluation). On the same date, they projected returns on the foreign reserves of USD 594 m and USD 754 m for 2021 and 2022 respectively.

The scenario is different now. The positive surprise with respect to profits in 2020 should be seen as a one-time event since there is no prospect of additional price increases due to additional reductions in external interest rates as they are close to zero. Going forward, a significant reduction in the profitability of the foreign reserves can be expected due to the low level of foreign interest rates and the fact they are not expected to rise in the short term.

1.9 Public Finances

The state of public finances affects risk premia, interest rates, capital flows, the confidence of economic agents, and the growth of the GDP along with many other relevant economic variables. Hence the importance of the monetary authority carefully monitoring the state of and outlook for public finances. This will make good coordination between monetary and fiscal policies possible and contribute to the design of a macroeconomic policy that ensures the stability and economic growth of the country.

As in other countries around the world, the Covid-19 pandemic produced a negative shock to the Colombian fiscal situation unlike any seen before. In 2019, the central national government (CNG) had achieved the lowest fiscal deficit since 2014 and the first primary surplus since 2012. In this context, the public finances were expected to continue a gradual adjustment of the deficit in compliance with the fiscal rule. The pandemic thwarted that positive momentum as the figures at the close of the previous year show. Between 2019 and 2020, the total CNG deficit tripled as it went from 2.5% to 7.8% of the GDP. The primary balance went from a 0.4% surplus of the GDP to a 4.9% deficit of the GDP. The gross debt came to 64.8% of the GDP at the end of 2020 compared to a level of 50.3% of the GDP in 2019.

These results did not come as a surprise to the government, which maintained control of the situation. In fact, in the *Medium-Term Fiscal Framework* (MTFF) that the Ministry of the Treasury submitted to Congress in June 2020, a total deficit of 8.2% of GDP was forecast for the CNG, one that was 0.4% of the GDP higher than what was finally seen. Thus, the government was aware that the emergency created by the pandemic merited an increase in the deficit and public indebtedness that would allow them to have the necessary funds to mitigate the economic effects of the crisis and to protect the most vulnerable people. In accordance with the above, the national government, having consulted the Fiscal Rule Advisory Committee and received a favorable and unanimous opinion, decided to invoke Act 1473, article 11 to suspend parametric compliance with the rule for 2020 and 2021 to have the fiscal flexibility needed to deal with the effects of the pandemic and in recognition of the uncertainty regarding the duration and depth of the shocks. The risk rating agencies also understood this when they decided to maintain Colombia's investment grade in spite of the fiscal deterioration and give the government a period of respite while it undertook the announced fiscal reform and the economy makes progress on its recovery.

According to the 2021 Financial Plan, the total deficit of the CNG will be 0.8% of the GDP higher than what was registered in 2020 and amount to 8.6% of the GDP at the end of the current year. The higher deficit is mainly due to the expenses required to meet the health emergency that came to 1.7% of the GDP and the investments that amounted to 1.3% of GDP and are intended to boost the economic recovery. The emergency costs include the purchase of vaccines, increased health insurance needs, the expansion of extraordinary transfers for the poor and vulnerable through government social programs. With respect to reactivation, the plan is to fast-track the implementation of infrastructure projects that boost economic activity and generate employment. Therewith, the gross debt of the CNG will probably rise marginally in 2021 to 65.2% of the GDP since the expected recovery in the level of output is likely to cushion the effect of the higher deficit on the debt ratio.

In view of this fiscal picture, the government has announced the need to submit a bill to the Congress of the Republic within the next few weeks that includes adjustments in both income and expenditures that will make it possible to improve the primary balance by at least 1.5% of the GDP on a recurring basis as of 2022 once the effects generated by the pandemic are overcome. This will make it possible to reduce the public debt to prudential levels and lower the risk of losing the investment grade rating for our sovereign debt.

1.10 Business Continuity

Given its strategic role in the functioning of the country's economic system, management at *Banco de la República* has always given special importance to the handling of operational risks. One of the most important areas in this field is business continuity, which is understood as the institution's ability to continue operating under extreme conditions. The risk that had received the most consideration was that of an earthquake affecting the facilities of *Banco de la República* in Bogota and a reaction strategy had been designed for that. However, a pandemic like that generated by Covid-19 had not been considered.

Therefore, this situation posed major challenges for the administration. It required a timely adjustment to the regulations and making decisions that would favor the adoption of measures in different areas. In the technological field, collaborative work tools were implemented in the cloud, and equipment was provided to enable mobility and remote work by employees. The reinforcement of IT security plans provided reliable working environments for the Bank, the financial sector, and the government in the services provided. These actions were basic for the non-interruption of any of the central banking activities.

At the beginning of the pandemic, the Bank had policies on information management (physical and electronic) and the use of digital signatures. It had also been implementing the electronic corporate content manager (*iConecta*) for some time, which allowed it to react quickly to the demands of the moment.

The production, access, and digital and digitized (scanned) signature on electronic documents (meeting legal requirements) allowed all the departments to carry out their duties supported and sustained by appropriate document management without detriment to the attributes that are granted to the Bank's documents such as authenticity, reliability, usability, confidentiality, integrity, and availability.

Regarding the processes of generation and distribution of monetary species and that is work that must be carried out in person, shifts were established to maintain this vital service for the country. The transportation companies provided the remittance services to the different branches without incident and in compliance with all biosecurity protocols.

The Human Resources area provided the employees with support in the areas of benefits, health, and monitoring of health conditions to ensure the application of biosecurity measures. The accelerated implementation of biosafety protocols enabled workers to maintain their health and has supported the continuity of the Bank's services and processes as well as being prepared for a return to an in-person situation. In addition, all the regulations issued by the national government to address the situation presented have been implemented.

Banco de la República's cultural management has also adapted to the new circumstances to continue to offer leisure and high-quality culture. The use of multiple digital platforms, the generation of content and virtual activities from the regions, the encouragement of participation and interaction through social networks, and audiovisual production were used for this purpose as is detailed in chapter 5 of this report. Thanks to that, it was possible keep audiences loyal and reach new ones at the national and international levels.

There is no doubt that the most important factor for ensuring business continuity and allowing *Banco de la República* to continue serving the country was the responsibility, sense of belonging, and commitment of each one of its members to this institution. The agile way in which the Bank's personnel adapted to remote work was outstanding, and they continued the teamwork that is indispensable for completing the complex tasks required by the entity. For all of this, the BDBR recognizes the huge effort that each and every one of their employees have made.