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Working Papers from the Board of Directors Banco de la República

Monetary Policy Report

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Board of Directors
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Monetary Policy Report

Economic Studies Division

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I. External Context and Balance of Payments

1. The available information suggests that global activity would have continued recovering, driven mainly by the advanced economies. Despite this, inflation continues to be persistently low, particularly in recent months and in the advanced economies.
2. The recent low inflation and its persistence could lead the United States and the euro zone to a slower normalization of monetary policy than had been expected earlier.
3. As forecast, the United States' growth accelerated in the second quarter, thanks to consumption and non-residential investment. To July, the labor market continues to record good growth rates in employment and a steady decline of the unemployment rate.
4. Similarly, the euro zone has also reported good results in terms of economic activity. Consumer and entrepreneur confidence to August continues at high levels, based on the perception of greater political stability.
5. In Latin America, the figures available on economic activity to the second quarter exhibit slight recovery in Mexico, Chile, and Colombia.
6. In general terms, inflation would have also shown a downward trend in emerging economies to July. Mexico continues to be the exception in Latin America, where a significant acceleration continues to take place.
7. In recent weeks, the Latin American currencies continue exhibiting stability or a slight trend towards appreciation.
8. Colombia's terms of trade to June are still above the low levels of 2016. However, there is a slight downward trend so far in 2017.
9. Regarding the price of oil, in recent weeks, the news about lower inventories in the United States and on commitments of lower production by some members of OPEC appear to have helped to stabilize prices close to the technical staff's forecast (USD $51/barrel Brent reference).
10. In July, there were significant capital inflows to emerging economies once more. In Latin America, however, these flows were lower, and were concentrated in equities, since there were outflows in fixed income. CDS in Latin America continue to be stable.

Exports of Goods

11. In June, exports in US dollars registered an annual 0.8% growth due to the 12.7% increase in the group of other exports[1]. On the other hand, external sales

[1] This excludes oil and its derivatives, coal, nickel, gold, coffee, bananas, and flowers, and includes other mining and agricultural goods. In June, exports of manufactured goods accounted for 94.6% of this group.

of agricultural and mining goods exhibited annual reductions (-1.3% and -4.5%, respectively). (See Table 1). No declines had been observed in these two groups since November 2016 (except in April this year for agricultural goods).

Table 1: Behavior of Exports in US dollars

	Annual Variation [Contribution]	Item	Annual variation of the item	Contribution to annual variation
June 2017				
		Main contributing items to annual variation, in the same direction:		
Total Exports	0.8%			
Agricultural goods	-1.3%	Coffee	-23.5%	-1.5
	[-0.2]	Banana	-30.6%	-1.3
Mining goods	-4.5%	Oil	-9.6%	-3.0
	[-2.6]	Coal	-9.6%	-1.4
Other exports*	12.7%	Foods, beverages, and tobacco, excluding coffee	25.3%	1.2
	[3.6]	Motor vehicles and other transport	54.0%	0.8
Accumulated value for January - June 2017				
Total Exports	20.4%			
Agricultural goods	8.3%	Coffee	12.9%	1.0
	[1.4]	Flowers	7.9%	0.4
Mining goods	36.4%	Coal	55.6%	7.6
	[18.6]	Oil	24.8%	6.7
Other exports	1.5%	Non-metal minerals and basic metals	20.2%	0.5
	[0.5]	Foods, beverages, and tobacco, excluding coffee	5.8%	0.4

* Within this group, the destinations that contributed the most to growth were Ecuador, rest of ALADI[2], and the European Union, with 80.2%, 25.7%, and 37.0% annual increases in June, respectively.
Source: DANE

12. On the other hand, so far this year, total exports have grown 20.4% annually, in response to the increase in external sales of the three groups of goods, particularly the increase in mining goods (36.4%). The annual variation of the rest of exports stepped up to a positive level (1.5%) after four months with negative figures (from February to May this year).
13. As for the accumulated value for this year, exports grew as a result of improvements in prices, reflected in their index, with a significant 23.4% annual increase, while the figure for quantities decreased 2.1%. This improvement in prices took place in the three groups of goods, with those of mining origin standing out (36.4% variation on a yearly basis).
14. According to the preview for foreign trade by DIAN, exports excluding oil and its derivatives increased 61.8% on a yearly basis in July mainly due to external

[2] Latin American Integration Association (ALADI), excluding Venezuela, Ecuador, Peru, and Mexico.

sales of coal and coffee. (According to this source, this group of exports had varied 6.1% in June; however, later reports by DANE indicated 7.9%).

Imports of Goods

15. In June, CIF imports in US dollars registered an annual 2.5% increase, mainly explained by the increase in external purchases of the three groups of goods, particularly raw materials and capital goods (Chart 2).
16. Regarding consumer goods, June recorded a 2.1% annual variation explained by the greater imports of non-durable goods, which increased 7.5%. Durable goods fell 4.2% annually.
17. In the month, transport equipment (capital goods) and fuel (raw material) fell 31.1% and 21.0%, respectively, contributing -2.9 pp to the annual variation of total imports.

Table 2: Behavior of Imports in US dollars

	June 2017			
	Annual Variation [Contribution]	Main contributing items to annual variation, in the same direction: Item	Annual variation of the item	Contribution to annual variation
Total Imports	2.5%			
Capital Goods	2.7%	Fixed equipment for industry (others)	16.6%	0.9
	[0.8]	Parts and accessories for transport equipment	11.2%	0.5
Raw materials	2.6%	Mining products	16.8%	1.4
	[1.2]	Chemical and pharmaceutical products	9.1%	1.4
Consumer Goods	2.1% [0.5]	**Non durable consumption goods**	**7.5%**	**1.0**
		Food products	14.9%	0.7
		Durable consumption goods	**-4.2%**	**-0.5**
		Vehicles for private use	-13.6%	-0.8
	Accumulated Value for January - June 2017			
Total Imports	6.0%			
Capital Goods	9.1%	Transport equipment	44.2%	1.3
	[2.7]	Fixed equipment for industry (others)	10.4%	0.6
Raw materials	6.1%	Mining products	10.6%	0.9
	[2.8]	Chemical and pharmaceutical products	6.1%	0.9
Consumer Goods	2.0% [0.5]	**Non durable consumption goods**	**-0.4%**	**-0.1**
		Food products	-3.0%	-0.1
		Tobacco	-29.6%	0.0
		Durable consumption goods	**5.0%**	**0.5**
		Private transportation vehicles	3.9%	0.2
		Domestic machines and appliances	7.7%	0.2

Source: DANE

18. So far this year, total imports have increased 6.0% on a yearly basis, based on increases in the three groups of goods. In this period, the indexes for quantities and prices showed 4.7% and 1.2% annual increases, respectively. This would suggest that, despite the fact that the increase in imports is due to a combined effect, the contribution of the quantities, focused on capital goods, is more relevant.
19. According to the preview for foreign trade by DIAN, CIF imports recorded an annual 12.2% increase in July. (According to this source, they had grown 3.1% in June; however, the figure reported later by DANE was a 2.5% increase).

Balance of Trade for Goods

20. The trade balance in the first half of 2017 shows a deficit of 4,346 million FOB US dollars. This indicates a 28.4% reduction in the deficit compared to the same period last year, due to higher growth of exports (20.4%) versus imports (6.0%).

II. Growth, Domestic Demand, and Credit

21. GDP growth in the second quarter of the year was 1.27% on a yearly basis, slightly above the forecast by the technical staff at the Central Bank in the previous Inflation Report. This result meant a 0.7% increase between quarters, which corresponds to an annualized 3.0% increase.
22. Breaking down by components, domestic demand grew 1.9% compared to the same period of 2016, slightly above the record for the first quarter (1.5%). This is mainly explained by the acceleration of consumption, and specifically by the dynamics of the public component, which grew 4.2% on a yearly basis; private consumption grew 1.4% per year. Gross capital formation also exhibited a better performance than in previous quarters, and grew at a rate similar to what was expected. Net exports contributed negatively to GDP growth, largely due to external sales of oil and coffee (Table 3).

Table 3

	2016				2016	2017	
	1st Q	2nd Q	3rd Q	4th Q	Whole Year	1st Q	2nd Q (Observed)
Total consumption	**3.0%**	**2.3%**	**0.9%**	**1.8%**	**2.0%**	**1.7%**	**2.1%**
Household consumption	2.8%	2.1%	1.0%	2.2%	2.0%	1.3%	1.4%
Non-durables	3.4%	2.2%	1.2%	1.4%	2.1%	1.4%	2.6%
Semi-durables	1.2%	1.1%	-1.5%	-0.8%	0.0%	-4.1%	-3.6%
Durables	-4.6%	-5.6%	-3.7%	11.2%	-0.8%	6.0%	-3.4%
Services	3.4%	3.1%	1.9%	2.4%	2.7%	1.7%	2.1%
Government final consumption	3.8%	3.0%	0.2%	0.4%	1.8%	2.6%	4.2%
Net Capital Formation	**-4.1%**	**-4.7%**	**-6.2%**	**-3.1%**	**-4.5%**	**0.0%**	**1.4%**
Fixed net capital formation	-4.0%	-4.0%	-3.6%	-2.9%	-3.6%	-0.8%	1.1%
Farming, forestry, hunting and fishing	6.1%	7.4%	4.2%	-0.7%	4.2%	3.9%	3.5%
Machinery and equipment	-15.2%	-12.3%	-18.8%	-13.8%	-15.1%	-3.7%	2.8%
Transport equipment	-20.6%	-7.2%	-14.6%	-4.8%	-11.9%	8.1%	-1.2%
Construction and building	10.7%	1.2%	10.6%	0.7%	5.6%	-7.5%	-7.9%
Civil works	-1.0%	0.8%	3.8%	6.1%	2.4%	3.8%	6.9%
Services	2.9%	-1.3%	4.4%	1.3%	1.8%	3.7%	0.5%
Domestic Demand	**1.3%**	**0.5%**	**-1.1%**	**0.5%**	**0.3%**	**1.5%**	**1.9%**
Total Exports	**0.9%**	**1.8%**	**-3.5%**	**-2.8%**	**-0.9%**	**-4.7%**	**-1.7%**
Total Imports	**-5.9%**	**-3.6%**	**-10.8%**	**-4.2%**	**-6.2%**	**-0.4%**	**3.7%**
GROSS DOMESTIC PRODUCT	**2.5%**	**2.5%**	**1.2%**	**1.6%**	**2.0%**	**1.2%**	**1.3%**

Source: DANE, calculations by *Banco de la República*

23. Per branch of activity, the sectors that grew most in that quarter were agriculture and financial services. In contrast, mining and industry exhibited significant contractions (Table 4). By classifying the sectors into non-tradable and tradable, annual variations were 2.4% and -0.5%, respectively. The tradable GDP excluding mining grew 0.7% on a yearly basis.

Chart 4

Real annual GDP growth per economic activity

Branch of activity	2016				2016	2017	
	1st Q	2nd Q	3rd Q	4th Q	Whole Year	1st Q	2nd Q
Farming, forestry, hunting and fishing	-0.2%	0.8%	-0.5%	1.9%	**0.5%**	**7.8%**	**4.4%**
Mining and quarrying	-4.6%	-6.9%	-6.4%	-8.3%	**-6.5%**	**-9.3%**	**-6.0%**
Manufacturing	4.2%	5.5%	1.3%	1.0%	**3.0%**	**0.3%**	**-3.3%**
Electricity, gas and water	2.8%	-0.6%	-1.4%	-0.6%	**0.1%**	**-0.5%**	**1.2%**
Construction	5.2%	1.1%	6.7%	3.4%	**4.1%**	**-1.4%**	**0.3%**
Buildings	11.1%	2.2%	10.9%	0.7%	**6.0%**	**-7.1%**	**-7.4%**
Civil works	-0.5%	0.9%	4.0%	5.1%	**2.4%**	**3.5%**	**6.5%**
Retail, repairs, restaurants, and hotels	2.8%	1.9%	0.7%	1.7%	**1.8%**	**-0.5%**	**0.9%**
Transportation, warehousing, and communications	0.9%	0.2%	-1.4%	-0.3%	**-0.1%**	**-0.3%**	**0.7%**
Financial, real estate, and corporate services	4.3%	5.3%	4.7%	5.4%	**5.0%**	**4.3%**	**3.9%**
Social, community, and personal services	3.5%	3.6%	1.0%	0.9%	**2.2%**	**2.9%**	**3.0%**
Subtotal value added	2.6%	2.3%	1.3%	1.5%	**1.9%**	**1.1%**	**1.1%**
Taxes minus subsidies	1.3%	4.0%	0.4%	2.9%	**2.2%**	**2.7%**	**3.3%**
GROSS DOMESTIC PRODUCT	2.5%	2.5%	1.2%	1.6%	**2.0%**	**1.2%**	**1.3%**

Source: DANE, calculations by *Banco de la República*

24. The information available for the third quarter is still scarce, and does not allow determining a forecast for GDP growth with certainty. However, some

indicators suggest that performance of the economic activity during this period would be better than the one registered a year ago. In part, this is due to a low basis for comparison for the same period of 2016 for several sector indicators, as a result of the trucking strike in July 2016. By branch of activity, there were setbacks associated with that strike in the activities related to transport (-1.4%), agriculture (-0.5%), electricity, gas, and water supply (-1.4%), and industry excluding oil refining (-2.2%).

25. With information to July, the Consumer Confidence Index (ICC) by Fedesarrollo continued to show slight increases *vis-à-vis* the records from previous months. This recovery took place both in the component of economic conditions as well as in the prospects for households. Despite this, it still continues in negative terrain, below the average calculated since November 2001.
26. Also with figures to July, vehicle registration records published by ANDI and Fenalco increased 6.2% on a yearly basis, compared to a very low level in the same month of 2016 due to the trucking strike. The increases took place both in vehicles for private use (5.5%) as in those for commercial use (7.0%). The levels observed are lower than in previous months, and the trend component of the series continues to exhibit deterioration.
27. Regarding the labor market, the seasonally adjusted series to June show a slight reduction in the unemployment rate nationwide, but an increasing trend for nearly a year for that of the thirteen areas. This is consistent with an almost null growth of annual employment in these areas. For this same geographical domain, with information to the moving quarter ending in June, the seasonally adjusted series exhibit a yearly increase in salaried and formal employment, and a reduction of non-salaried and informal employment.
28. On the other hand, imports of capital goods to July (source: DIAN) in constant pesos suggest that during this month investment on capital goods other than buildings and civil works would have grown, although at a slower pace than recorded for the accumulated value for the second quarter.
29. On the supply side, the available information exhibits uneven results. For the industry and retail, figures indicate they would continue weak, while for mining, agriculture and energy demand there have been favorable news.
30. In July, total energy demand increased 3.3% on a yearly basis. The trend of the series continued to increase. Both regulated energy demand (3.5%) and non-regulated (3.0%) exhibited expansions in July.
31. Oil production ranked at 856 thousand daily barrels in July, which meant an annual 1.6% expansion.
32. According to the figures of the Federation of Coffee Growers, coffee production stood at 1,373,000 60-kg bags, which represents a yearly 24.6

expansion. This indicator had fallen sharply in July 2016. So far this year, this sector has grown 1.3%.

33. In contrast, in July, the indicators for orders and stocks of the Business Opinion Survey (EOE) by Fedesarrollo continued pointing at a weakening of the industrial sector. On the other hand, the expectations of industrial production for the next three months also declined slightly. The trend component exhibits a significant decline since a year ago. With all of this, industrial confidence decreased slightly and maintains its negative trend so far this year.
34. Something similar occurs in the EOE survey in July, where retailers appeared to be less optimistic in the face of the current situation and to the perception on the prospects compared to the June report. The trend component exhibits a negative slope in both cases.
35. Thus, with the updated information on GDP for the second quarter and the dynamics recorded by the different indicators for the third quarter, the Central Bank's technical staff maintains the growth forecast for 2017 at 1.6%, within a range between 1.0% and 2.0%. This projection is consistent with an acceleration of growth in the second half of the year at a rate of around 2.0%, on average.

III. Behavior of Inflation and Prices

36. Annual consumer inflation fell again in July, standing at 3.40%, *vis-à-vis* 3.99% in the previous month. This completes one year of uninterrupted falls in this indicator (**Table 5**).
37. For the year so far, the accumulated inflation has been 3.30%, a figure below the record in the same period last year (5.65%).
38. Monthly inflation in July was -0.05%, lower-than-expected by the market (0.12%) and by the technical staff.
39. Although all groups contributed to the fall of annual inflation in July, the contraction concentrated in the CPI for food and regulated items.
40. Core inflation, measured by the average of the four indicators monitored by the Central Bank, fell again (from 5.09% in June to 4.90% in July). During the first months of the year, this average presented no significant changes, standing around 5.5%; however, since May, it has exhibited significant declines.
41. As it happened last month, all core inflation indicators declined in July. CPI excluding food (from 5.12% in June to 4.79% in July) and the CPI excluding primary food, fuel, and public utilities (from 5.07% to 4.88%) fell the most. Smaller declines were observed in the CPI excluding food and regulated items (from 4.87% to 4.72%), and in the Core 20 CPI (from 5.31% to 5.22%) (**Table 5**).

Table 5

Headline and Core Inflation to July 2017

Description	Weight	Dec 2016	Apr 2017	May 2017	June 2017	July 2017	Participation percentage in monthly deceleration	Participation percentage in deceleration of the year to-date
Headline inflation	**100**	**5.75**	**4.66**	**4.37**	**3.99**	**3.40**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.14**	**5.60**	**5.35**	**5.12**	**4.79**	**40.11**	**12.58**
Tradables	26.00	5.31	5.35	4.88	4.41	4.09	12.73	12.66
Non-tradables	30.52	4.85	5.22	5.25	5.21	5.20	1.68	(3.38)
Regulated items	15.26	5.44	6.75	6.24	6.01	5.03	25.70	3.30
Food inflation	**28.21**	**7.22**	**2.49**	**2.09**	**1.37**	**0.20**	**59.89**	**87.42**
Perishables	3.88	(6.63)	(14.47)	(14.13)	(14.72)	(16.92)	23.47	25.74
Processed food	16.26	10.74	5.12	4.39	3.29	2.24	28.44	56.39
Eating out	8.07	8.54	8.08	7.79	7.62	7.10	7.97	5.30
Core inflation indicators								
Non-food inflation		5.14	5.60	5.35	5.12	4.79		
Core 20		6.18	5.84	5.59	5.31	5.22		
CPI excluding perishable foods, fuel and utilities		6.03	5.37	5.29	5.07	4.88		
CPI excluding food and regulated items		5.05	5.28	5.09	4.87	4.72		
Average of core inflation indicators		**5.60**	**5.52**	**5.33**	**5.09**	**4.90**		

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

42. Within the CPI excluding food, annual variations in the sub-groups of tradables and regulated items declined again in July. Variation of the non-tradable CPI remained stable.
43. The biggest fall was concentrated in the CPI for tradables (from 4.41% in June to 4.09% in July). Thus, the shock originated in the depreciation of the exchange rate observed in previous years has continued to fade slowly, added to the weakness of domestic demand so far in 2017, which has been mainly reflected on a fall in consumption of durable and semi-durable imported goods.
44. The downward trend of the annual CPI variation in tradables last year had been interrupted at the beginning of 2017 due to the transitional impact that the increase in the VAT and other indirect taxes brought on these rates. The effect of the shock is expected to disappear in the first quarter next year.
45. In July, as well as in recent months, the stability of non-tradable CPI inflation stands out, whose annual variation has remained around 5.2%. Within this sub-group, the drop in the annual variation for leases in July (from 4.3% in previous months to 4.2%) should be noted. As for indexed items (including the prices of education and health services, among others), the adjustment remained at 6.9%, as can be observed since February. These prices have not yet responded to the poor performance of domestic demand.
46. Annual variation in regulated items fell from 6.01% in June to 5.03% in July. All of its components fell, except for fuels. The annual adjustment of public utilities fell the most (from 5.01% in June to 3.09% in July). Also, transport decreased from 6.06% to 5.83%. Fuel was the only non-tradable component of

the CPI that increased (from 9.08% to 9.15%), despite the COP 46 fall in the price of gasoline decreed in July.

47. It must be noted that starting January 2018, there could be upward pressures on the CPI for public utilities should the significant increases recently announced by the office of the Mayor of Bogotá for garbage collection rates take place. Something similar, although sooner, would happen regarding taxi fares in Bogotá, due to the change in the technological platform and updating of prices that should take place in October. It is estimated that these changes would imply a 7.0% adjustment of the rates.
48. Annual food variation completed a year falling uninterruptedly, standing in July at 0.2%, compared to 1.37% in June. As happened in the previous month, in July, all the components of the food CPI fell again. Processed items went from 3.3% to 2.2% (due to minor adjustments in the prices of beef and chicken); perishable foods fell from -14.7% to -16.9% (thanks to falls in the prices of banana and some vegetables); meals outside the home fell from 7.6% to 7.1%.
49. It is worth noting that, due to the basis of statistical comparison and to the normal agricultural cycle (captured by the models of the Central Bank), the downward trend in annual food inflation would have ended in July. Thus, some increases in this indicator are expected in the coming months which would impact annual consumer inflation, as shown herein.
50. Regarding non-labor costs, in July the descending path of the PPI was interrupted. Indeed, annual adjustment of the PPI for domestic supply (domestically produced and consumed items plus imported goods) rose from -0.83% in June to -0.30% in July. This behavior is explained by the increase in the annual variation of imported goods (from -0.66% in June to 1.21% in July). In contrast, the annual variation of the local component of the PPI (-0.95%) did not exhibit significant changes.
51. Labor costs exhibited mixed results, according to the latest information available. Wages in the manufacturing industry adjusted to an increasing annual rate between May (6.5%) and June (7.3%), while those for retail fell from 5.4% to 4.7%. On the other hand, annual adjustments of wages for housing construction (5.8%) and heavy construction (4.4%) remained stable. Despite the slack in the labor market, wages continued adjusting to rates which are much higher than the inflation target.
52. According to the latest monthly survey to financial analysts by the Central Bank (applied at the beginning of August), inflation expectations to December this year continued falling, while those to a longer term increased. Expected inflation to December 2017 dropped from 4.28% in July to 4.16% in August. Inflation expectations to twelve months increased slightly from 3.60% to 3.62%, and those to twenty-four months did so from 3.38% to 3.42%.

53. Inflation embedded in public debt bonds (Breakeven inflation, BEI) extracted from the TES denominated in pesos and UVR to August 29 is at 3.00% to 2 years. 3.18% to 3 years, and 3.38% to 5 years. Compared to the average in June, average BEI increased 8, 11, and 12 bp for these same horizons, respectively.
54. Finally, using the Forward Break-Even Inflation (FBEI) curve, the estimation of annual inflation for 2017 is 4.61% (obtained by adding the accumulated inflation observed to the inflation expectations for the remainder of the year). For 2018, 2019 and 2020 it is 3.43%, 3.60%, and 3.69%, respectively.