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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

Banco de la República

Monetary Policy Report

Economic Studies Division

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I. External Context and Balance of Payments

1. The new information on the foreign context shows few changes with respect to the previous month. The global economy seems to have continued its recovery driven primarily by the advanced economies.
2. The US labor market continues to register growth in employment and declines in the unemployment rate (UR). Nevertheless, this situation has not translated into meaningful pressure on wages.
3. At their December meeting, the US Federal Reserve raised its policy interest rate by 25 bp within the 1.25 – 1.50% range, as was anticipated.
4. Consumer and business confidence in the euro zone remains at high levels as of November.
5. Inflation remains low in advanced economies despite some recent increases. This is in spite of the positive dynamics of output and the labor market.
6. Regarding oil, the Brent prices remained relatively high in the last few weeks compared to what had been expected in previous reports, standing around USD 63/b. The better outlook for global demand and the extension of the OPEC agreement to mid-2018 explain this performance.
7. In Latin America, the figures available on economic activity exhibit a slight recovery in all of the countries monitored.
8. Latin American currencies have remained stable in recent weeks. The reduction of Colombia's credit rating by Standard and Poor's (S&P) on Monday, December 11 was accompanied by a 0.3% depreciation of the peso with respect to the end of December 7.
9. Significant capital flows into emerging economies continued to be seen in November. With respect to Latin America, inflows from fixed income and outflows in variable income were seen for that same month. In Colombia, based on the exchange market balance, the country received USD 415 m from portfolio flows during November. This was the third highest monthly amount of the year after March and April. USD 447 m in portfolio flows entered in the October-November 2-month period.
10. CDS in the region have remained stable and at low levels during the last few weeks.

Balance Of Payments

11. The current account of the country's balance of payments registered a deficit of USD 8.363 b (3.7% of the GDP) between January and September 2017 (**Table 1**), which is lower than the one from a year ago when it stood at USD 9.677 b

(4.8% of the GDP). It should be noted that the value of the current deficit for the third quarter (USD 2.589 b, 3.4% of the GDP) was higher than what had been estimated and presented in the last quarterly report (USD 2.239 b, 2.9% of the GDP).

12. The data published on the balance of payments as of September, indicate a downward revision of the current deficit in the first half of the year close to USD 345 m. This compensated for the forecast error in the third quarter such that the country's accumulated current deficit as of September (3.7% of the GDP) is in line with what was estimated in the last quarterly report. Given this and the limited information available for the fourth quarter, the technical staff made no alterations in the current deficit forecast for 2017 (3.7%, between 3.4% and 4.0%).

Table 1.

BALANCE OF PAYMENTS (millions of dollars)	January - September	
	2016	**2017**
CURRENT ACCOUNT (A+B+C+D)	-9.677	-8.363
Percentage of GDP	*-4.80%*	*-3.70%*
A. Goods	-7.51	-4.819
Exports	24.309	28.237
Imports	31.819	33.056
B. Non-factor Services	-2.591	-2.874
Exports	5.66	6.14
Imports	8.251	9.014
C. Factor Income	-3.742	-5.391
D. Transfers	4.166	4.721
FINANCIAL ACCOUNT (A+B+C+D)	-10.261	-7.644
A. Direct Investment (ii-i)	-7.931	-7.354
i. Foreign Investment in Colombia (IED)	10.532	10.202
ii. Colombian Investment Abroad	2.601	2.848
B. Portfolio Investment	-2.501	-2.33
C. Other Investments (loans, credits, and other derivatives)	143	1.668
D. Reserve Assets	29	373
ERRORS AND OMISSIONS	-584	719

13. The lower current deficit over the course of the year is explained by the growth in income (USD 5.418 b), especially because of the increase in exports of goods. This more than offset the increase in outlays (USD 4.104 b) due to the higher outflows of profits from companies with foreign direct investment (FDI) in the mining-energy sector, the growth in imports of goods and services, and the higher interest payments on the foreign debt.
14. Specifically, the reduction of the current deficit (USD 1.314 b) was primarily explained by the lower trade deficit in goods (USD 2.691 b), which more than offset the increase in the net outflows due to factor income (USD 1.649 b) and the increase in the services deficit (USD 283 m). The increase in current transfers (USD 555 m) also contributed to the decline in the foreign deficit.
15. From the beginning of 2017 to September, foreign capital inflows totaled USD 14.966 b, while capital outflows to purchase assets abroad came to USD 6.835 b. Of the total inflows, FDI was the main source of financing, representing 68%. The purchase of TES on the part of foreign investors and the placement of

public debt securities on the international markets by the government and other public sector entities contributed 34%; while net repayments of loans and other flows were registered (**Table 1**).

16. In comparison to what was seen a year ago, the financial account of the balance of payments as of September 2017 registered USD 2.616 b in lower net capital flows. This is largely due to the lower purchase of TES by foreigners and the repayment of loans made by public sector entities, which contrasts with the net disbursements received a year ago.

Exports of Goods

17. In October, the dollar value of the total exports registered an annual 15.1% growth because of increases in the three groups of goods, especially due to the foreign sales of mining products (**Table 2**). The contribution from coal and crude oil stands out, with significant increases in the prices for both products (although the second one registered a decrease in quantity).
18. Foreign sales from the 'remaining exports' group[1] continue to exhibit positive levels that are close to the maximum for the last two years (excluding the particular level in August 2016 when there was a rebound after the trucking strike) and presenting an annual change of 7.0% for October.
19. The agricultural group, in turn, grew mainly through the contribution of bananas[2] and of coffee.

[1] Excluding crude oil and its derivatives, coal, nickel-iron, gold, coffee, bananas, and flowers. It includes other mining and agricultural products. Exports of manufactured products represented 96.6% of this group in October.

[2] Of the value registered for exports of banana, 82.6% corresponds to statements made in October but shipped in previous months.

Table 2. Trend of US dollar-denominated exports

	October 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 Exports	15.1%			
Agricultural goods	16.0%	Bananas	63.9%	0.9
	[1.8]	Coffee	11.4%	0.8
Mining goods	19.5%	Coal	45.1%	6.3
	[11.1]	Oil	20.3%	5.8
Other exports*	7.0%	Foods, beverages, and tobacco, excluding coffee	30.7%	1.6
	[2.2]	Non-metal minerals and basic metals	19.4%	0.5
Accumulated value for January - October 2017				
Total Exports	19.2%			
Agricultural goods	13.7%	Coffee	19.3%	1.4
	[2.0]	Flowers	7.0%	0.3
Mining goods	28.5%	Coal	53.9%	7.9
	[15.2]	Oil	20.6%	5.6
Other exports	6.2%	Foods, beverages, and tobacco, excluding coffee	17.8%	1.1
	[2.0]	Non-metal minerals and basic metals	24.8%	0.6

*Significant annual growth of foreign sales of this group of products to Ecuador, the European Union, and the United States were registered (16.7%, 43.0%, and 5.6% respectively) while sales to Mexico, and Venezuela shrank 9.6%, and 15.9% respectively.
Source: DANE

20. The change in total exports, which stood at 19.2% so far this year, surpassed the monthly change; also explained by an increase in sales abroad of the three groups of goods, especially those products that come from mining (28.5%).
21. The annual change so far this year in the remaining exports group (6.2%) stayed positive for the fifth consecutive month after more than three years of negative figures (from January 2014 to May 2017, with the exception of January of this year).
22. The year-to-date accumulated value of exports has grown as a consequence of the improvement in prices with a substantial 14.2% annual increase, while the quantity index has barely grown 0.8%. This improvement in prices has occurred in the three groups of products, though mining products have stood out with a variation of 21.7% annually
23. According to the foreign trade preview by DIAN, exports excluding oil and its derivatives registered an annual 8.0% increase in October. Based on this same source, an approximation is found of the variation for the 'remaining exports' group that is equal to 17.0%.

Imports of Goods

24. DANE has not published the value of the imports for October. Table 3 shows the data as of September where the dollar CIF value of imports registered a yearly slump of 5.6%. This shows the poor performance of the purchases abroad of the three groups of goods. The most important decline was registered in capital goods; the majority of its segments contracted, the most relevant one being the decrease in aircraft[3]imports.

25. According to the foreign trade preview by DIAN, CIF imports registered a 9.4% annual growth in October. For November, the preview exhibits a yearly decline of 4.1% partly explained by the high basis for comparison with the previous year.

Table 3. Trend of US dollar-denominated Imports

	Annual Variation [Contribution]	Main contributing items to annual variation, in the same direction: Item	Annual variation of the item	Contribution to annual variation
September 2017				
Total Imports	-5.6%			
Capital Goods	-10.0% [-3.1]	Transport Equipment	-44.3	-2.8
		Capital Goods for Industry	**1.1%**	**0.2**
		Office Machines and Appliances	-12.3%	-0.6
Raw materials	-3.9% [-1.7]	Food for Livestock (Agriculture)	-36.5%	-0.8
		Chemical and Pharmaceutical Products for Indus	-5.0%	-0.7
Consumer Goods	-2.9% [-0.7%]	**Non durable consumption goods**	**-2.4%**	**-0.3**
		Pharmaceutical Products and Toiletries	-9.8%	-0.4
		Durable consumption goods	**-3.5%**	**-0.4**
		Decoration, Personal Use, and Other Objects	-9.4%	-0.2
Accumulated Value for January - September 2017				
Total Imports	4.4%			
Capital Goods	7.4% [2.2]	Transport Equipment	27.8%	0.9
		Capital Goods for Industry	**3.5%**	**0.7**
		Others - Fixed Equipment for Industry	12.2%	0.7
Raw materials	3.7% [1.7]	Mining Products	10.6%	0.9
		Chemical and Pharmaceutical Products	3.2%	0.5
Consumer Goods	1.8% [0.4]	**Non durable consumption goods**	**0.8%**	**0.1**
		Clothing and other textiles	16.3%	0.2
		Durable consumption goods	**3.1%**	**0.3**
		Domestic Machines and Appliances	7.8%	0.2

Source: DANE

[3] According to the customs tariff handbook, imports of aircraft or space navigation products (associated with aircraft) fell 42.4% on a yearly basis, thus contributing -2.1 percentage points to the decline of the group and of the total imports. This chapter is included in the segment of transportation equipment presented in Table 3.

II. Growth, Domestic Demand, and Credit

26. The information on the fourth quarter of 2017 is still too limited to revise the forecast for economic activity. Nevertheless, the trends recently seen of the available indicators, together with those presented in the previous monthly report, continue to point to a growth for the fourth quarter that would probably be lower than in the third (2.0%) but higher than the growth in the first half of the year (1.3%).
27. The lower growth has probably resulted partly from a relatively high basis for comparison from the same period in 2016 (due to the end of the trucking strike, the automobile fair, etc.).
28. The few indicators for the fourth quarter support the above. Based on the figures as of November, the number of license registrations for vehicles shrank 5.7% compared to the same month last year. Although increases were seen compared to the mid-year levels even when controlling for seasonality, the trend component for the series continued to show a declining slope. This is just as true when the license registrations for private vehicles (-9.1%) and the commercial vehicles segments (-2.0%) are analyzed.
29. In addition, once the balance of sales of the EMEE of the BR in October are corrected for seasonal effects, it suggests a weak private consumption for that month.
30. With respect to the labor market, this has continued to deteriorate slowly despite the fact that the seasonally adjusted series ending in October exhibits few marginal changes in the unemployment rate (UR) at the national level and that of the 13 most important metropolitan areas. The latter is maintaining its growth trend, which has continued for more than a year. In line with this, the seasonally adjusted figures for October show that employment in the national total is presenting marginal declines and in the thirteen areas, it is exhibiting practically no growth. Despite that, for this geographical domain, the figures as of October indicate that wage-paying employment is growing and non-salaried employment is falling in both annual terms and marginally.
31. Growth of loans to households continued its slowdown in November, primarily fueled by the trend of consumer loans. Furthermore, the transmission of the reductions in the benchmark rate to the lending rates for households remains low in comparison to the transmission to commercial loans rates.
32. With respect to gross capital formation, the seasonally adjusted series of the balance of investment expectations of the EMEE suggests that investment, other than in construction of buildings and civil works, performed poorly in October.
33. In addition, according to the information from the DIAN preview of foreign trade as of November, the recent imports of capital goods (carried in constant pesos) makes it possible to predict that the growth of this segment of investment

will probably slow down compared to the third quarter of the year. However, this would be the result of lower dynamics on the transportation equipment side rather than the machinery and equipment one.

34. On the supply side, the few indicators available exhibit mixed trends and reflect a growth of the Colombian economy that is below its potential.
35. According to the Fedesarrollo survey, the industry orders and inventory indicators exhibited a slight increase in October in comparison to the previous month. The trend components suggest that the sector weakening is likely to continue. The indicator of production expectations, in turn, exhibited a slight setback. All of this led to a setback of the Industrial Confidence Index (ICI) in October.
36. With respect to retailers, the same source reported an improvement in the balance of the current situation outlook, using data as of October. Nevertheless, the future prospects for business remained unchanged at mediocre levels.
37. Coffee production was 1.3 million bags in November, which indicated an annual contraction of 21.4%. So far this year, output has exhibited a setback of 2.1%.

III. Behavior of Inflation and Prices

38. Annual consumer inflation in November was 4.12% surpassing the figure for October by 7 basis points (bp) (Table 4). This is the fourth consecutive increase since a minimum was reached recently in July of this year (3.40%).
39. Inflation for the year as of November (3.69%) was lower than what had been seen for the same period last year (5.31%).
40. The monthly change of 0.18% in November was greater than the 0.11% change in November 2016 and surpassed the market forecast for monthly inflation (0.11%) and that of the Central Bank´s technical staff.
41. The increase in annual inflation over the last month was mainly explained by the upturn in the annual adjustment of perishable food, tradable items, and, to a lesser extent, the one for non-tradable items. In contrast, the changes in the CPI for regulated items, processed food, and meals outside the home put downward pressure on annual inflation.
42. Core inflation, measured as the average of the four indicators monitored by *Banco de la República* broke with the downward trend it had been on for the first time since August of 2016, standing at 4.54%. This was 4 bp above the figure from the previous month.
43. The trend of the core inflation indicators was mixed in November: the CPI excluding basic food, fuel, and public utilities (from 4.13% in October to 4.09% in November) and the core 20 CPI, the one with the highest level, (from 4.73%

to 4.69%) declined; the CPI excluding food and regulated items (from 4.44% to 4.57%) rose the most, followed by the CPI excluding food (from 4.70% to 4.80%).

44. Within the CPI excluding food, the annual variation for the sub-group of tradables excluding food and regulated items went from 3.38% in October to 3.64% in November, above the expected. This increase is the first one that has been registered in this segment of the CPI since the beginning of the year, when the increase in the VAT had its strongest effect on its tradable component. At this time, the upturn in the annual variation was concentrated in vehicles and airline tickets, which was due both to greater than expected increases in the level of their prices during the month and a low statistical basis of comparison. With vehicles, the automobile showroom contained increases in November of last year, something that did not happen this month (0.49%). The recent air transportation strike made airfares increase in November of this year by 1.09% monthly when there had been a significant decline during the same month in 2016.

Table 4. Consumer Price and Core Inflation Indicators

Headline and Core Inflation to November 2017

Description	Weight	Dec 2016	Aug 2017	Sept 2017	Oct 2017	Nov 2017	Participation percentage in monthly deceleration	Participation percentage in deceleration of the year to-date
Headline inflation	**100.00**	**5.75**	**3.87**	**3.97**	**4.05**	**4.12**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.14**	**4.81**	**4.71**	**4.70**	**4.80**	**97.91**	**15.68**
Tradables	26.00	5.31	3.75	3.41	3.38	3.64	82.57	24.20
Non-tradables	30.52	4.85	5.23	5.21	5.23	5.27	21.44	-7.33
Regulated items	15.26	5.44	5.57	5.68	5.61	5.58	-6.10	-1.19
Food inflation	**28.21**	**7.22**	**1.69**	**2.22**	**2.51**	**2.52**	**2.09**	**84.32**
Perishables	3.88	-6.63	-6.81	-0.32	3.20	5.89	157.21	-35.24
Processed food	16.26	10.74	1.71	0.84	0.52	-0.15	-151.94	105.18
Eating out	8.07	8.54	6.30	6.01	5.78	5.75	-3.19	14.38
Core inflation indicators								
Non-food inflation		**5.14**	4.81	4.71	4.70	4.80		
Core 20		6.18	5.00	4.87	4.73	4.69		
CPI excluding perishable foods, fuel and utilities		6.03	4.56	4.31	4.13	4.09		
CPI excluding food and regulated items		5.05	4.59	4.44	4.44	4.57		
Average of core inflation indicators		5.60	4.74	4.58	4.50	4.54		

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

45. The annual change in the non-tradables also rose (from 5.23% in October to 5.27% in November). That increase was fueled by the upturn in the rentals subgroup (that went from 4.22% in October to 4.30% in November). This increase was not anticipated, but it is hoped that this does not indicate a trend given the weakness of demand and the abundant supply of real estate for sale and rent.

46. Within the CPI for non-tradables, the annual variation for the subgroup of more indexed items was maintained without significant changes (6.95%) while the variations for the sub-group of prices that are more affected by the exchange

rate (6.57%) and for the rest of the items (which includes soccer tickets) (5.27%) declined. Be advised that a significant increase is expected for the CPI of this latter sub-group in December, which should revert at the beginning of 2018 on account of the capital teams that qualified for the Colombian soccer finals.

47. The annual change in regulated items fell in November (5.58%) with respect to October (5.61%). This decline was concentrated in the segments of fuel (which went from 9.83% to 8.28%) and transportation (from 4.35% to 4.32%). In contrast, the annual change for public utilities rose (from 5.39% to 5.82%) partly because of the increase in gas rates in Bogotá.
48. Utilities could put upward pressure on inflation in the first few months of next year given the announcement by the mayor of Bogotá regarding increases in garbage collection rates. Likewise, in the case of transportation, starting in December a 100-peso readjustment in the fare for buses, mini-buses, and micro-buses (provisional SITP) was put into effect in Bogotá, which would also probably put some upward pressure on the CPI. Added to this is the implementation of the new technological platform for charging for taxi services in Bogotá as of next year (a close to 7.0% increase has been estimated).
49. With respect to annual inflation of food prices, these remained relatively stable in November (2.52%) after three consecutive increases. Even so, this result exceeded the technical staff's forecasts. Within the group, perishable food put upward pressure (mostly due to increases in the price of potatoes and some vegetables) on the CPI, which was offset by declines in the prices for processed food (owing to the sharp drops in the prices for rice, sugar, and oil, etc. that have continued) and, to a lesser degree, by those for meals outside the home.
50. As was mentioned in the previous report, the increase in annual food price inflation in previous months was associated with a low basis for comparison from the same period last year, when the prices contracted once the upward shock caused by El Niño and the trucking strike was overcome. In this respect, the current upturn is not associated with a lower supply of agriculture products, which remains ample judging by the high growth of the agricultural GDP (this surpassed 7.0% in the third quarter) and the high availability of food supplies in the last few months including November.
51. The recent reports from international meteorological agencies point to the presence of a La Niña event in the coming months (one that would be weak and short-lived). The stylized facts in the past show that rainfall that is greater than the national average favors higher yields in agricultural work in general.
52. The increases in non-labor costs, approximated by the PPI, became more moderate in November after rising for four consecutive months. The annual PPI inflation for the total domestic supply (produced and consumed domestically plus imports) went from 1.38% in October to 1.31% in November. This decline

in annual producer inflation is due to the imported component, which went from 0.85% to -0.62%. In contrast, the annual change in the local PPI went from 1.61% to 2.16%.

53. According to *Banco de la República's* most recent monthly survey of financial analysts (done at the beginning of December), inflation expectations for the end of this year rose between the November survey (3.95%) and the one for December (4.01%). In contrast, the expectations to 12 months from the present (from 3.54% to 3.46%) and 24 months from the present (from 3.37% to 3.27%) declined.
54. Inflation embedded in public debt bonds (Break Even Inflation, BEI), which is drawn from the peso-denominated TES and UVR up to this point in December (as of the 12th), stands at 3.45%, 3.45%, 3.47%, and 3.61% for 2, 3, 5, and 10 years respectively. With respect to the average for November, the BEI varied between 22 bp, 15 bp, 7 bp and 2 bp respectively for these same horizons.
55. Using the Forward Break-Even Inflation (FBEI) curve, the estimate for annual inflation in 2017 is 3.98%, which is lower than the 4.05% estimated in November (obtained by adding the accumulated current inflation to the expected inflation for what remains of the year.) For the years 2018, 2019, and 2020, this corresponds to 3.47%, 3.49%, and 3.53% respectively.