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Banco de la República

Monetary Policy Report

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Monetary Policy Report - November 2016

I. External Context and Balance of Payments

1. The Fed's FOMC increased its benchmark interest rate 25 bp in its December meeting. According to its forecast, there would be three 25-bp increases in 2017, while only two were expected a few months ago. However, the market expects only two increases after the announcement. This took place within a context in which GDP for the third quarter was revised upwards to 3.2% (a.q.), and other indicators such as confidence, retail, and labor-market indicators suggest that dynamism of the economy continues in the fourth quarter. Analyst's forecast for headline inflation is at 1.8% for the fourth quarter, and around 2.3% for 2017. The figure for November was 1.7%.
2. The European Central Bank modified the size, duration, and composition of the asset-purchase program in its last meeting. These policies would intend to make the yield curve steeper, and to improve the transmission of the monetary policy. According to the new plan, starting January and finishing in December 2017, the amount lowered from 80 to 60 billion euros, and purchase of bonds yielding below the ECB deposit rate was allowed. It is worth noting that, in the euro zone, annual inflation increased to 0.6% in November, this being the highest figure in almost three years.
3. Available data suggest that growth of the country’s trading partners would have remained modest, despite good results in the US and that some indicators suggest that growth in China and the euro zone continues.
4. In the euro zone, indicators of retail sales to October and consumer confidence and manufacturing PMI to November suggest an increase in the economic activity in the fourth quarter versus the two previous quarters, in line with the forecasts published in the previous quarterly report.
5. For China, retail sales and the PMI for services exhibited increases in November. The economy continues with the adjustment process towards a model more supported by consumption. Although growth data are close to the Chinese government's target, there are concerns regarding a sharp deceleration and probable financial instability, given the over-indebtedness of the economy.
6. As for Latin America, GDP third quarter results for Peru were higher than those observed in the second, in line with the forecasts by the technical staff. For the fourth quarter, the figures of economic activity for Chile suggest a slowdown. Additionally, negative growth rates are expected in Brazil, Ecuador, Venezuela, and Argentina. However, in Brazil, economy would contract less than in previous quarters.

7. Headline inflation in Chile and Mexico is within their target ranges; however, this is not so in Perú, where recent increases pushed inflation out of its target. In Brazil, inflation relented in October, but remains away from its target range.
8. Meanwhile, currencies in the region have appreciated in the last weeks, partly as a consequence of the increase in the prices of oil and copper. In Colombia and Chile, they are close to the levels observed prior to the US presidential elections.
9. The country's terms of trade would have increased recently, particularly thanks to the increase in the oil price. This is due to the agreement reached by the members of the OPEC, which other oil-producing countries have also joined, in order to reduce global production and thus regulate high inventories. Although the agreement is of a greater-than-anticipated extent, it is expected to be fulfilled partially, and that production in the US reacts once the increase in prices takes place, mitigating its scope.
10. Regarding global financial markets, volatility indexes have returned to low levels, while the long-term interest rates of developed economies have increased (mainly those of the US), as have done stock market indicators. The risk premia for Latin America fell in the past weeks.

Exports

11. In October, the value of exports in US dollars registered a yearly 3.8% fall due to decreases in all groups, particularly agricultural goods (-7.8%). To date, exports have fallen 18.9% mainly due to the sales of mining goods (-25.6%) **(Table 1).**

Table 1: Behavior of Exports in US dollars

October 2016			
	Annual Variation	Main contributing items: Item	Annual variation of the item
Total	-3.8%		
Agricultural goods	-7.8%	Banana	-53.4%
Mining goods	-3.1%	Oil	-31.8%
Other exports*	-3.5%	Foods, Beverages and Tobacco, excluding Coffee Machinery and Electric Appliances	-20.2% -28.9%
Accumulated value for January - October 2016			
Total	-18.9%		
Agricultural goods	-7.8%	Coffee	-16.5%
Mining goods	-25.6%	Oil Coal	-42.9% -5.0%
Other exports*	-10.5%	Chemical Products Foods, Beverages and Tobacco, excluding Coffee	-12.3% -8.5%

* Within this group, the destinations which contributed most to the fall were Venezuela, the European Union, and Perú, with annual reductions of 61.6%, 39.9%, and 13.0%, respectively.

Source: DANE

12. So far this year, the price index for total exports has registered a significant drop (-16.5%), while the volume index has fallen moderately (-3.1%). However, in October, the reduction in the value of exports was explained mainly by the behavior of the volume.
13. According to the preview for foreign trade by DIAN, exports excluding oil and its derivatives increased 10.8% on a yearly basis in November (according to this source, they had grown 6.2% in October; however, the increase reported later by DANE was 8.5%).

Imports

14. According to the preview for foreign trade by DIAN, the value of CIF imports in US dollars fell 18.9%, and 6.4% annually in October and November. The data on imports by DANE for October 2016 will be published on December 19.

II. Growth, Domestic Demand and Credit

15. The results of economic growth in the third quarter were below the expectations of the technical staff at the Central Bank (1.2% observed versus 1.6% forecast), which confirmed the downward bias of the GDP growth projections presented in the previous Inflation Report.
16. On the demand side, aggregate consumption decelerated at a faster-than-expected pace, and investment exhibited a significant contraction, in line with the forecast. Exports and imports also showed negative growth rates **(Table 2)**. Altogether, net exports contributed to GDP growth, although at a lesser magnitude than forecast by the Central Bank. On the supply side, the sectors that grew the most were construction, financial services, and industry. Mining, agriculture, utilities (energy, gas, water) and transport exhibited contractions **(Table 3)**.
17. The information available for the fourth quarter is still scarce, but it suggests a slightly higher economic growth than in the third quarter. This is partly due to the fact that some supply shocks that took place in the third quarter would have been overcome. Should this be the case, GDP growth for 2016 would post in the lower part of the forecast range presented in the previous quarterly Inflation Report (1.5% to 2.5%, with 2.0% as the most likely figure).
18. In October, the seasonally adjusted series for the sales balance of the monthly survey on Economic Expectations by *Banco de la República* (EMEE by its acronym in Spanish) fell again, posting at lower levels than those registered in the third quarter and all of 2015. This suggests that the pace of growth for household consumption would continue to be mediocre in the fourth quarter.

19. Something similar happened with the seasonally adjusted series for the balance of investment expectations from the same survey. The figure for October fell marginally versus that for September. Although the level observed was greater than the records for the first half of the year, it is still far from the average for 2015.

Table 2

Branch of activity	2015	2016		
	Whole Year	1st Q	2nd Q	3rd Q
Total consumption	**3.9%**	**2.9%**	**2.3%**	**1.3%**
Household consumption	3.8%	3.3%	2.4%	1.1%
Non-durables	4.1%	3.4%	2.7%	1.2%
Semi-durables	4.6%	3.6%	2.8%	0.2%
Durables	-2.0%	-5.2%	-5.1%	-3.1%
Services	4.2%	4.1%	2.9%	1.5%
Government final consumption	2.8%	1.6%	1.6%	1.2%
Net Capital Formation	**2.6%**	**-3.3%**	**-3.1%**	**-7.3%**
Fixed net capital formation	2.8%	-3.1%	-1.9%	-3.4%
Farming, forestry, hunting and fishing	-1.5%	-0.7%	0.0%	-1.2%
Machinery and equipment	-1.8%	-11.1%	-7.6%	-14.7%
Transport equipment	9.4%	-18.8%	-5.0%	-15.5%
Construction and building	2.7%	11.5%	2.7%	11.3%
Civil works	5.2%	0.3%	-0.5%	2.2%
Services	0.9%	1.9%	0.3%	-1.2%
Domestic Demand	**3.6%**	**1.5%**	**1.0%**	**-1.1%**
Total Exports	**-0.7%**	**2.3%**	**4.1%**	**-1.5%**
Total Imports	**3.9%**	**-2.5%**	**-1.4%**	**-8.4%**
GROSS DOMESTIC PRODUCT	**3.1%**	**2.5%**	**2.0%**	**1.2%**

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

Table 3

Branch of activity	2015	2016		
	Whole Year	1st Q	2nd Q	3rd Q
Farming, forestry, hunting and fishing	3.3%	0.7%	-0.1%	-1.7%
Mining and quarrying	0.6%	-4.6%	-7.1%	-6.1%
Manufacturing	1.2%	5.3%	6.0%	2.0%
Electricity, gas and water	2.9%	2.9%	-0.8%	-1.8%
Construction	3.9%	5.2%	1.0%	5.8%
Buildings	2.1%	10.9%	2.8%	11.0%
Civil works	5.4%	0.4%	-0.4%	1.9%
Retail, repairs, restaurants and hotels	4.1%	2.7%	1.4%	0.1%
Transportation, warehousing and communications	1.4%	1.8%	0.1%	-1.2%
Financial, real estate, and corporate services	4.3%	3.8%	4.6%	3.9%
Social, community and personal services	2.9%	1.7%	2.3%	1.8%
Subtotal value added	**3.0%**	**2.5%**	**1.9%**	**1.1%**
Taxes minus subsidies	**4.0%**	**2.3%**	**2.8%**	**1.8%**
GROSS DOMESTIC PRODUCT	**3.1%**	**2.5%**	**2.0%**	**1.2%**

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

20. The figures for imports of capital goods by DANE and the trade bulletin from DIAN (in constant pesos) confirm the prospects of contraction of gross fixed-capital formation (different from construction), although at a rate no greater than in the third quarter.

21. According to the *Comité Automotor Colombiano* (Colombian Automotive Committee formed by *Andi*, *Fenalco*, and *Econometría*), the number of license registrations increased 6.6% in November versus the same month in 2015. This increase was due to the 15th Automobile Exhibition. The number of registrations for private vehicles increased 4.5% on a yearly basis, while those for commercial vehicles did so 9.0%. This will be reflected on the dynamics of durable consumption and investment in transport equipment in the fourth quarter, which should be somewhat better than in the third.

22. On the supply side, the indicators available also suggest a lower performance of the economy during the fourth quarter, *vis-á-vis* the observations from the first half of the year.

23. With data to October, the indicators of industrial confidence by Fedesarrollo suggest that the current situation and the prospects of the industry deteriorated versus the records form the third quarter. Something similar happened with the confidence indicators for retail. The survey by *Fedesarrollo* for the same month exhibited a slight deterioration in the perception of the current situation; however, future prospects for business improved.

24. Regarding construction, cement production in October contracted 11.0% on a yearly basis, a fall greater than the one registered in the third quarter (-9.1%)

25. Additionally, according to the *Agencia Nacional de Hidrocarburos* (National Hydrocarbons Agency ( ), in November, oil production was 855 thousand barrels per day, on average, which implied a yearly contraction of 13.4%. So far this year, the average production stood at 890 mdb, lower by 11.4% than in 2015. In spite of this, production showed a slight recovery in recent months from the levels registered midyear.

26. As for the labor market, with data to October (moving quarter seasonally adjusted series), few changes were seen on the unemployment rate. Rural areas were the outstanding exception, for which an important fall due to an acceleration of employment was observed. This variable continues exhibiting stagnation in the national total and in the thirteen areas. Despite this, an increase of salaried jobs is noticeable in the thirteen areas.

27. Finally, in November, commercial indebtedness (foreign currency adjusted to correct for the fluctuations of the exchange rate) registered a 5.7% yearly increase, as in October, but lower than in previous months. The dynamics of household credit continues, with an annual growth rate close to 13%.

III. Behavior of Inflation and Prices

28. Annual inflation in November fell for the fourth consecutive month (5.96%) after reaching the ceiling in July 2016 (8.97%) **(Table 4)**. Accumulated inflation so far this year amounted to 5.31%, a figure lower than a year ago (6.11%). Monthly variation was 0.11%, lower than expected both by the market (0.14%) and the technical staff at *Banco de la República*.

Table 4

Headline and Core Inflation - to November 2016

Description	Weight	Dec 2015	Mar 2016	Jun 2016	Sept 2016	Oct 2016	Nov 2016	Participation percentage in monthly acceleration	Participation percentage in acceleration of the year to-date
Headline inflation	**100.00**	**6.77**	**7.98**	**8.60**	**7.27**	**6.48**	**5.96**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.17**	**6.20**	**6.31**	**5.92**	**5.64**	**5.31**	**46.22**	**(7.02)**
Tradables	26.00	7.09	7.38	7.90	7.20	6.49	5.74	**33.36**	38.51
Non-tradables	30.52	4.21	4.83	4.97	4.85	4.81	4.83	**(0.06)**	(20.81)
Regulated items	15.26	4.28	7.24	6.71	6.19	6.07	5.64	**12.92**	(24.72)
Food inflation	**28.21**	**10.85**	**12.35**	**14.28**	**10.61**	**8.53**	**7.54**	**53.78**	**107.02**
Perishables	3.88	26.03	27.09	34.94	6.66	(2.18)	(4.94)	25.48	161.22
Processed food	16.26	9.62	10.83	12.09	12.56	11.75	10.89	23.34	(28.67)
Eating out	8.07	5.95	7.53	8.11	9.18	8.64	8.36	4.96	(25.53)
Core inflation indicators									
Non-food inflation		5.17	6.20	6.31	5.92	5.64	5.31		
Core 20		5.22	6.48	6.82	6.73	6.58	6.33		
CPI excluding perishable foods, fuel and utilities		5.93	6.57	6.77	6.65	6.37	6.08		
CPI excluding food and regulated items		5.42	5.91	6.20	5.84	5.52	5.22		
Average of core inflation indicators		**5.43**	**6.29**	**6.52**	**6.29**	**6.03**	**5.74**		

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

29. The reduction in headline inflation is explained by the food CPI (mainly perishable and processed) and by the CPI for tradables (excluding food and regulated items). Regulated items also contributed to the reduction of inflation, but to a lesser degree.

30. Core inflation, measured by the average of the four indicators monitored by the Central Bank, moved from 6.03% in October to 5.74% in November. All indicators fell, with the CPI excluding perishable foods, fuels, and utilities as the lowest (5.22%), and Core 20 the highest (6.33%) **(Table 4)**. Annual inflation excluding foods posted at 5.31%, 33 bp lower than in October.

31. Within the CPI excluding food, the most outstanding event was the reduction of the yearly variation of the CPI for tradables (excluding food and regulated items) from 6.49% in October to 5.74% in November. This subgroup completed five months of successive

declines, which suggests that the pass-through of the accumulated depreciation between mid 2014 and the first months of 2016 would be close to an end.

32. On the other hand, annual non-tradable CPI variation was 4.83% in November, thus completing 10 months relatively stable within a range between 4.8% and 5.0%. Specifically, the annual CPI adjustment for leases remained at 4.0% this month. The majority of other items in this subgroup adjusted to rates higher than 4.0%. They are still affected by indexation mechanisms, inflation expectations, and by salary adjustments higher than the ceiling of the target range.

33. As for regulated items, annual variation descended in November (5.64%) *vis-à-vis* October (6.07%). This behavior is explained by the reduction in public utilities (from 8.93% in October to 6.81% in November). In contrast, the subgroups of transport and fuels increased.

34. As for food, annual CPI variation stood at 7.54% in November, completing four months descending from a recent 15.71% ceiling in July. The reduction was 99 bp versus October. The falls in this variable are related with the disappearance of *El Niño* and the recovery of food supply after the trucking strike in July. The greater falls were observed in the perishable food CPI (-4.94% vs. -2.18% in October). Processed foods and eating–out also exhibited reductions in their annual variations, although they continue to be high (10.89% and 8.36%, respectively). For the latter, it is worth noting that in previous episodes of *El Niño*, its annual variation started to fall with a three-month lag versus the rest of the food CPI.

35. The pressures of non-labor costs tended to increase in November, especially due to the depreciation that took place this month. Annual variation of the PPI for domestic supply (domestically produced and consumed items plus imported goods) rose from 3.48% in October to 3.91% in November. Imported PPI increased from 0.24% to 1.83% in November, while the PPI for domestically produced and consumed goods fell from 4.95% to 4.86%.

36. To date, there is no information on labor costs different from the one presented in the previous Report.

37. According to the most recent survey to financial analysts (applied at the beginning of this month), inflation expectations to December 2016 are 5.60% (versus 5.69% from the previous survey). Inflation expectations to twelve and twenty four months increased from 4.18% to 4.36%, and from 3.57% to 3.58%. Inflation expectations embedded in TES in pesos and UVR (Breakeven Inflation) on average to 14 December, compared to average data for November, increased 17 and 4 bp for 2 and 3-year terms, respectively, and decreased 9 bp for the 5-year term. Thus, the average data for BEI so far in December for these terms stand at 4.35%, 4.06%, and 3.79%, respectively.