



**BANCO DE LA REPÚBLICA
DIVISION OF ECONOMIC STUDIES**

Monetary Policy Report of December 2014

I. International Context and Balance of Payments

1. The fall in international oil prices, which started in July 2014, continued during December and the first days of January. This is explained, to a large extent, by a weak outlook for global economic growth and by the persistence of excess supply for this commodity. Additionally, the main producing countries have stated that they would not reduce their supply.
2. International prices of other commodities have also fallen in the last few weeks, mainly as a consequence of the lower outlook for global economic growth and of the reduction in energy costs. In this context, the prices of the main commodities exported by Colombia and of some agricultural commodities imported by this country have decreased.
3. The figures of real activity in the United States up to December indicate that the economy exhibited a good behavior during the fourth quarter. In addition, some indicators, such as household and business confidence, kept improving and suggest that dynamism could continue during the first part of 2015.
4. The figures for December show that the US labor market continued recovering, as shown by a larger than expected increase in employment: the unemployment rate fell to 5.6%, and the alternative indicators monitored by the Federal Reserve, such as the underemployment and the long-term unemployment rates, continue improving.
5. December annual inflation in the United States decreased by 50 basis points (bp) from the previous month and posted 0.8%. This reduction is mainly explained by the strong fall in fuel prices. Inflation, excluding energy and food, dropped slightly to 1.6%. Despite the aforesaid, the press release issued by the Federal Open Market Committee (FOMC) still suggests that the first rise of its benchmark rate would occur at the beginning of the second semester of 2015, and would be implemented gradually.
6. As for the euro zone, the real activity and confidence indicators show that the economy grew at a very weak pace during the fourth quarter, suggesting an unfavorable outlook for 2015. Additionally, the results of elections in Greece have increased the uncertainty in the region's financial markets. The euro zone entered deflation in December, since its annual inflation posted -0.2% as a result of the fall in fuel prices and of economic weakness. In this context, the European Central Bank (ECB) increased its assets purchase program in 50 billion (b) euros per month (for a total of 60 b euros per month), and included sovereign bonds among the eligible assets. This program will extend at least until September 2016.
7. As for emerging economies, GDP figures in China for the fourth quarter show that the economy slowed down, expanding 7.4% for all the year. In Latin America, real activity indexes for November in Brazil, Chile, Mexico and Peru show low growth for these countries.
8. Inflation in emerging economies kept showing a heterogeneous outlook: in the majority of Asian countries, especially in China, it has decreased in recent months; in contrast, a growing trend continues in Latin America, although it has moderated.

9. Volatility indexes of the financial markets increased last month as a result of: the strong movements in commodity markets; the uncertainty over the actions that the ECB would take; and due to the political situation in Greece. In this context, the long-term sovereign bond rates of the United States and of the euro zone (excepting Greece) kept falling in the last few weeks, while the US dollar appreciated versus the main currencies of the world.
10. As for the financial markets in Latin America, the risk premia remained high, while currencies showed a heterogeneous behavior. On the one hand, the currencies of Brazil, Colombia and Mexico remained relatively stable after the strong depreciation displayed in the second semester of 2014; while, on the other, the Chilean peso and the new Peruvian sol weakened in the last few weeks. On average, the Colombian peso depreciated 7.0% annually in 2014.

a. Exports and Imports

11. In November, total exports in dollars fell 22.6% annually, due to lower prices and quantities. Reductions in the exports of goods of mining origin (-32.4%) and of the group of other exports (-2.8%) explain this fall; while items of agricultural origin grew 19.7%, due, to a significant extent, by the increase in coffee sales (55.2%). The commodities that contributed the most to the fall in the group of mining products were oil (-27.9%) and its derivatives (-62,1%).
12. The lower foreign sales in the group of other exports are explained, to a great extent, by the fall in vehicles (-45.4%), meat (-77.8%) and chemical products (-4.0%). By destination, the greater reductions in this group were towards Brazil (-41.9%) and Mexico (-33.8%).
13. In the accumulated value for the year up to November, total exports decreased 4.7% from the same period of 2013, since the reduction in prices was not offset by the increase in the quantities exported. This reduction is explained by the lower foreign sales of mining commodities (-6.8%) and of the group of other exports (-4.9%). Among the first, lower values in refined goods (-32.2%) and oil (-3.0%) stand out; while for the second, those of vehicles (-38.4%), the rest of agricultural products (-38.6%) and meat (-65.5%) are worth mentioning. By contrast, exports of agricultural goods recorded a growth rate of 18.3% so far this year, with coffee contributing the most, with an annual variation of 31.6%.
14. In October, the dollar value of total CIF imports rose 9.3% annually, with increases in capital (18.1%), intermediate (5.9%) and consumer goods (3.7%). Among capital goods, the main items grew, highlighting transportation equipment (63.9%) and capital goods for the industry (1.7%). On the side of imports of intermediate goods, purchases of raw materials for the industry (5.1%) and fuels and lubricants (11.6%) registered increases; while in consumer goods, both non-durable (5,8%) and durable goods (1,8%) rose.
15. From the beginning of the year up to October, the total CIF imports recorded an annual growth rate of 7.6% thanks to the increases in raw materials (9.4%), consumer (8.4%) and capital goods (4.9%). The first increased mainly by growth in fuels and lubricants (20.3%) and raw materials for the industry (6.5%). For capital goods, the major increase was registered in those destined to

the industry (6.0%), followed by transportation equipment (4.4%). Finally, regarding consumer goods, the greater variation is that of durable goods, with a growth rate of 11.1%.

16. On the other hand, during November, total imports in dollars recorded a growth of 6.4%, driven by the increases in capital goods (17.1%) and consumer goods (9.8%). In turn, the imports of raw materials and intermediate goods fell 3.9%.
17. In the accumulated value from January to November, total CIF imports rose 7.5%, thanks to increases in raw materials (8.2%), capital goods (6.0%) and consumer goods (8.5%).

II. Projections of External Variables

a. Scenarios for external growth

Base or most likely scenario (Chart 1)

18. In the case of the United States, domestic demand fundamentals would remain in favorable conditions, and therefore consumption and investment would constitute the main engines of growth for the economic activity in 2015. Additionally, the fall in oil prices would favor a good behavior of household expenditure. Appreciation of the dollar and the weakness of the global demand suggest that exports would contribute very little to growth. The discussions regarding the debt ceiling, planned for March 2015, would not have a significant effect on the agents' confidence.
19. The figures for employment would be consistent with the dynamism expected from the economy, so the labor market would continue recovering. This way, the existing excess capacity would keep falling and some upward pressures on salaries would emerge. Nevertheless, low commodity prices and the US dollar appreciation would keep inflation low.
20. In this context, it is expected that the Federal Reserve increases its benchmark rate for the first time in the second semester of 2015 and continues with gradual raises during the remainder of the year.
21. In the euro zone, economic growth for 2015 would be weak, in spite of the positive effect that the fall in oil prices of oil may have on household consumption. However, the behavior per countries would be heterogeneous. On the one hand, the reforms adopted in some peripheral countries (such as Spain, Ireland, and Portugal) would favor the recovery of these economies. On the other, Germany would continue expanding at modest rates, while France and Italy would continue stagnant due to the structural problems they face.
22. The depreciation of the euro would boost exports, which, nevertheless, would still be affected by the weakening of emerging economies demand, especially from commodity exporters.
23. The political situation of Greece would still be an important source of uncertainty for Europe, but an exit of this country from the euro zone is not included in this scenario.

24. In the case of China, growth in 2015 would continue slowing, as a result of the gradual deregulation of financial markets and the rebalancing of the economy towards one driven by private consumption. In this context, it is expected that credit and fixed asset investment gradually continue reducing the dynamism shown in previous years. This way, part of the macroeconomic imbalances in this economy would be corrected.
25. In Latin America, a heterogeneous behavior among countries is expected. On one hand, Peru and Chile would show some recovery, as a result of the lower oil prices and of the stimulus provided by the public sector and by monetary policy. Similarly, Mexico would be favored by a greater momentum of the United States economy, which would offset the negative impact of the fall in oil prices. In contrast, the recovery of the Brazilian economy would be very weak, due to the fiscal consolidation that would take place in this country and to the low business and household confidence. Meanwhile, Venezuela would continue contracting because of its structural problems, which have intensified with the low international oil prices.
26. Regarding oil, the member countries of the Organization of the Petroleum Exporting Countries (OPEC) would not reduce their supply, seeking to maintain their market share. In this context, the prices would remain at the current levels or fall even more during the first part of the year, forcing a reduction in the production of non-conventional deposits with higher marginal costs towards the second semester of 2015. This way, oil prices would rise in the second half of the year, although they would remain below the levels reached in previous years.

Downside risks to the base scenario (low scenario) (Chart 1)

27. Non-conventional production of oil in North America would have lower costs than estimated, so supply would not fall during the second half of the year and prices would not increase or would fall even more.
28. Latin American economies, which are commodity exporters, could suffer a greater deterioration of their economic activities due to the fall in the terms of trade.
29. Volatility in financial markets could rise as a result of a further deterioration of the Russian economy.
30. Uncertainty about the fiscal sustainability of Greece would increase, thus raising its costs of financing and spreading to other economies of the region. A possible exit of Greece from the euro zone is considered in this scenario.
31. The deceleration in Chinese growth would be sharper than expected due to problems associated with its financial stability.
32. The measures of the ECB would be insufficient to boost the economy. The euro zone could enter a deflationary spiral, with significant consequences for its growth. Japan could also be facing this phenomenon.
33. A mistake in the monetary policy of the United States would take place, with potential adverse effects on the financial markets and on confidence worldwide.

Upside risks for the base scenario (high scenario) (Chart 1)

34. The fall in oil prices would have a larger than expected effect on global economic growth.
35. ECB measures would be more effective than expected and would give a greater boost to the credit market and to domestic demand.
36. The government and the Central Bank of China would adopt further plans to boost the expansion of the real activity, keeping high the growth rate of credit, investment, and residential construction.

Chart 1

Country or region	2014			2015		
	Low	Base	High	Low	Base	High
USA	2.3	2.4	2.5	2.4	3.0	3.6
Euro zone	0.7	0.8	0.9	0.2	0.9	1.6
China	7.2	7.3	7.4	6.4	7.0	7.5
Brazil	-0.1	0.1	0.2	0.0	0.7	1.2
Ecuador	3.4	3.8	4.2	2.0	3.0	4.0
Venezuela	-5.0	-4.0	-3.0	-6.0	-4.0	-2.0
Peru	2.6	2.8	3.0	3.0	4.7	5.5
Mexico	2.0	2.2	2.4	2.3	3.3	4.0
Chile	1.5	1.7	1.9	2.5	3.0	3.5

b. Projections for the balance of payments

37. Until the third quarter of 2014, the current account deficit widened to 4.6% of the GDP (compared to 3.3% of the GDP in September 2013). This, together with the evolution of international trade in the last part of the year, supports the projection of the balance of payments for 2014, which estimates a current account deficit between 4.8% and 5.2% of the GDP, with 5.0% as the base scenario. This reflects the deterioration in the country's external balance, which results mainly from the strong fall in oil prices, the supply shocks that affected coal and refined oil products during the year, and the dynamism of imports.
38. Consistent with this widening in the current deficit, capital flows for 2014 are estimated to be significantly higher than those registered a year ago. This is associated with greater portfolio investment flows during the year both in the local market of public debt (thanks to the re-balancing of the *JP Morgan* indexes) and in the international markets through the emission of bonds by the public sector. In turn, foreign direct investment is estimated to be lower in 2014, given the slowdown of the flows directed to the oil and mining sectors in the last months of the year. Nevertheless, investments of Colombians abroad are estimated to be lower, which results in greater net direct investment in the country. This would be partially offset by lower inflows from other investments (loans and deposits).

39. For 2015 the current account deficit as a percentage of the GDP is expected to fall and would be around 4.7%. This forecast incorporates the effect of the fall in oil prices on different external accounts: It is estimated that the deficit in the goods trade balance would widen due to a strong contraction of traditional exports, partially offset by the recovery of non-traditional exports and the reduction of imports; a reduction in the deficit of the services trade balance is projected, as well as a reduction in the net outflows for factor income, due to the lower remission of profits from the mining-energy sector.
40. The performance of external sales would be affected by the lower price forecasts for oil (US\$50/bl Brent) and for coal, which would be partially offset by with better outlook for the products of agricultural origin and the recovery of part of the exports of oil derivatives with the start of operations of Reficar at the end of the year. Additionally, a slight acceleration in the growth of external demand is assumed, and is mainly explained by the improvement that is anticipated for the United States economy, which, together with the expected depreciation of the Colombian peso, would boost external sales of non-traditional products. Regarding commodities, it is worth mentioning that quantities exported are expected to rise for all products along with the projections of growth of their production (3.2% oil; 5.0% coal and ferro-nickel, and 8.5% coffee).
41. This way, in the base scenario, exports of traditional products would fall approximately 32% (in dollars), while total exports would contract 21%. In turn, imports (in dollars) would contract from the figures observed in 2014 (-17.9% annually), due to a strong fall in the imports of capital goods for the mining-energy industry, a less dynamic domestic demand, and the reduction of the international prices of imported goods, especially of intermediate goods.
42. As for the financing of the deficit, it is expected that capital flows are lower than those projected for 2014, affected by decreased FDI resources and the reduction in the flows of foreign portfolio investment, in a context of better conditions for developed economies and possible advances in the monetary normalization in the United States.
43. Net foreign direct investment is projected to be lower than a year ago, mainly as a result of lower FDI resources for the oil and mining sectors, as well as a moderation in the flows to other sectors due to the estimated slowdown of domestic demand. Particularly, a fall of 25% in the investment on oil is assumed.
44. In turn, it is foreseen that the net financing from portfolio investment would be lower than the one observed in the previous year, due to a reduction in foreign capital flows to the local public debt market and a decrease in the emission of bonds in international markets by the non-financial public sector. This would be partially offset by greater flows from other investments (loans and deposits).
45. Finally, a sensitivity exercise of the base scenario of the balance of payments for 2015 was conducted by varying the assumptions on the conditions of foreign financing and on domestic growth. In the scenario in which the conditions of foreign financing are still positive and economic growth is 4.0%, the current account deficit would be 5.5% of the GDP. A lower foreign financing, together with less economic growth (2.0%), results in a deficit of 3.3% of the GDP.

III. Domestic Demand, Growth and Credit

46. The available information suggests that during the fourth quarter of 2014 the Colombian economy would have expanded at a pace slightly below the one of the third quarter, and lower than the average pace for the first half of the year. This occurred despite the dynamism of domestic demand.
47. According to the most recent edition of the Monthly Retail Trade Survey (EMCM) by the National Statistics Department (DANE), during November, retail sales expanded 8.8% from the same period of 2013. This corresponds to an annual growth of 11.0% for the two-month period of October-November, which is greater than the 7.7% registered in the third quarter. Excluding vehicle sales, the annual increase in this indicator was 8.1% and 10.1%, respectively, for the same periods.
48. The evolution of vehicle sales reported in the same survey suggests that the expansion of durable consumption in this quarter would be higher than the one registered during the third quarter. Vehicle retail sales grew 12.0% on a yearly basis during November, which meant an annual expansion of 15.2% for the two-month period of October-November. This is confirmed with the figures for car sales, published jointly by ANDI, Fenalco and Econometría. According to this, car sales increased 17.0% during the fourth quarter. It is worth mentioning that during this period the biennial event "Salón del Automóvil"¹ took place, which suggests a significant annual growth of this component of private consumption during the fourth quarter.
49. On the other hand, the results of the Monthly Economic Expectations Survey (EMEE), by Banco de la República, also indicate a good pace of expansion for household consumption during the fourth quarter of the year. The balance for sales expectations continues to be high, in line with the observations from the figures published by DANE.
50. In turn, the consumer confidence index for December, published by Fedesarrollo, showed a slight reduction from the previous month. Nevertheless, the average of the series for the fourth quarter of the year was greater than in the third quarter and also than in 2014.
51. Likewise, the recent performance of labor market indicators suggests a good behavior of household expenditure during the fourth quarter. For the moving quarter that ended in December, the unemployment rate kept falling on a yearly basis in all geographical domains, except for the rural zones, where a slight increase was observed. The reductions in the unemployment rate for the 13 areas is explained by increases in employment, particularly that of salaried employment, which continues growing yearly at a good pace.
52. In line with the above, yearly growth of consumption credit to households in nominal terms was 13.0% on average during the fourth quarter, which is greater than the one registered on average for the third quarter (11.8%).
53. Regarding gross capital formation, the balance of expectations of the EMEE suggests that investment, different from construction of buildings and civil works, would have expanded at a

¹ "Salón del Automóvil" is a biennial event, which gathers different car manufacturers in a convention center and is historically known for increasing car sales. (Translator's note).

pace similar to the one of the previous quarters. Additionally, the performance of capital goods imports indicates a two-digit increase rate in the expenditure on transportation equipment and machinery and equipment, similar to the ones registered during the third quarter.

54. As for foreign trade, the figures of exports for the two-month period of October-November suggest that these would have grown less during the fourth quarter than in the third. The low performance of industrial exports would have hindered this item of the GDP from growing at a favorable rate. Nonetheless, it is worth considering that there was a high base of comparison from a year ago.
55. Imports would have maintained a good growth pace during the fourth quarter, as shown by the trade records from DANE and DIAN.
56. On the side of supply, the indicators available for the industry show stagnation of the sector. The annual variation of the IPI without coffee threshing for November was -0.9%, while the trend component shows a significant fall.
57. Additionally, according to Fedesarrollo, industrial confidence decreased in December and was below its historic average. The trend component of the indicators of orders and inventories suggest a deterioration of industrial activity. Similarly, production expectations to three months decreased significantly and are below their historical average.
58. In the case of retail trade, the survey by Fedesarrollo for December shows that companies indicated a diminishment in their perception of the current and future situation of their business.
59. Some figures related with mining, particularly with oil, continued showing weak growth during the fourth quarter of 2014, although exhibited some improvement from the previous quarter. According to the National Hydrocarbons Agency (ANH), oil production in December registered one million seven thousand barrels per day. During the fourth quarter, one million three thousand daily barrels were produced on average, which means 0.2% growth, while a quarter before it had contracted 3.1%.
60. As for agriculture, with information to November, cattle slaughter showed a contraction of 6.9%, which is explained by the continuity of the cattle-raising retention cycle. In turn, although coffee production to December was above one million 60 kg-bags (1.086.000), this meant a contraction of 2.6% and an important slowdown in quarterly terms, since it expanded 1.2% yearly, after growing around 21% in the previous quarter.
61. Thus, on the supply side, the most dynamic sectors would be construction (of both buildings and civil works) and retail trade, which would favor from the dynamism shown by retail sales. Although the mining sector would record an improvement from three months ago, its expansion rate would only be slightly positive. In the case of the industrial GDP, no growth or just a slightly positive expansion is expected.