



PUBLIC VERSION

Working Papers from the
Board of Directors
Banco de la República

Monetary Policy Report



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Economic Studies Division

OCTOBER 2015

I. External Context and Balance of Payments

1. In November, Colombia's terms of trade would have fallen again, mainly because of the drop in international oil prices. The price of Brent oil fell 7.3% on average so far this month to the 24th, as compared to the observations from October. Appreciation of the US dollar and concerns about further weakness of global demand explain much of this fall. Additionally, there are indications that the levels of oil inventories remain high and that there would still be a global excess supply of oil.
2. The prices of nickel and of other metals exported by some countries in the region also declined significantly in recent weeks, mainly as a result of the appreciation of the US dollar and the lower demand from emerging economies. Meanwhile, the international price of coffee, while showing some increases *vis-à-vis* the previous month, continues at relatively low levels compared to last year.
3. The most recent records of global economic activity confirm the low growth of Colombia's major trading partners for 2015 *vis-à-vis* observations from previous years.
4. In the United States, the second estimate of GDP for the third quarter shows that economic growth would have exhibited moderation, moving from a 3.9% quarterly annualized rate (q.a.r) in the second quarter to 2.1% q.a.r. (Revised from 1.5% q.a.r.). By disaggregating it into its components, this lower expansion is mainly explained by a major disaccumulation of inventories (which subtracted 0.6 pp from growth) and by a negative net external demand. In contrast, household consumption and investment continue increasing at relatively high rates.
5. The figures of retail sales and consumer confidence to October remained high and suggest that household spending continues consolidating as the main engine of growth for the US economy. In contrast, industrial production remained stagnant. As for the labor market, job creation in October was high, with which the unemployment rate reduced to 5.0%. Regarding the yearly variation in prices, a modest increase was observed in total inflation, although it is still low (0.2%); meanwhile, core inflation indicators remained stable at 1.9%.
6. In this context, the minutes for the October meeting of the Federal Open Market Committee (FOMC) of the FED suggests that the interest rate would

be raised in December and would continue increasing gradually in the future. As a result of the above and of better than expected employment records, the likelihood of an increase in the benchmark rate at the end of the year (implicit in future financial markets) increased.

7. In the euro zone, GDP posted a quarterly growth rate of 0.3% between July and September, which represents a slight deceleration *vis-à-vis* the figures from the previous quarter (0.4%). Meanwhile, preliminary indicators for November for confidence and industrial surveys show that the economy would have continued to expand at a modest pace. Regarding the variation of prices, the indicators of total annual inflation and core inflation in October exhibited slight increases of 0.2 pp as compared to the observations from the previous month, posting at 0.1% and 1.1%, respectively.
8. In China, to October, the indicators of industrial production, fixed-asset investment and retail sales suggest that real activity continued exhibiting a relatively low dynamism. On its part, yearly inflation in said month remained low (1.3%).
9. In Latin America, GDP growth records for the third quarter in Chile and Mexico show some recovery as compared to data from three months ago, while Peru exhibited a slight moderation. In these economies, dynamism is low compared to that of previous years. The records of real activity to September for Brazil suggest a deepening of the contraction that began last year.
10. The records of inflation to October in Latin American economies continued to show a heterogeneous behavior among countries. In Chile and Peru inflation moderated slightly, although it remains above the upper limit of the target range of their central banks. In Brazil, inflation remains high and with a marked upward trend. In Mexico, inflation reduced again and is at the bottom of the target range of its central bank.
11. As for the international financial markets, the US dollar retook its trend towards appreciation *vis-à-vis* most currencies of the world; an increase in the rates of long-term bonds of the United States was observed, mainly as a consequence of the prospects of an increase in the benchmark interest rate by the Fed in December. On its part, the yields on long-term sovereign debt bonds of the main countries of the euro zone have exhibited some reductions, suggesting that agents of the financial markets would be expecting a greater monetary stimulus by the European Central Bank (ECB).

12.As for Latin America, risk premia have not presented significant changes so far in November and remain at relatively high levels. The region's currencies resumed their weakening trend *vis-à-vis* the US dollar. This behavior has been particularly marked in the case of the Colombian peso, which went from an average value of COP \$2,924 per dollar in October to COP \$2,986 per dollar so far in November to the 24th, which corresponds to a 2.1% depreciation.

a. Exports and Imports

13.Total exports in US dollars in September recorded a yearly fall of 43.4%, explained by a 58.2% decrease in the value of exported mining goods and a reduction of 12.5% for other exports. The fall in mining goods is mainly associated with lower exports of oil (-59.8%) and coal (-55.8%). In contrast, the item of agricultural goods exhibited an 8.7% variation due to the increase in coffee (15.7%) and flowers (4.2%).

14.Among other exports, the falls in foods and beverages (-18.3%) and vehicles (-52.9%) stand out. By destinations, the following falls stand out: 59.3% to Venezuela; 32.5% to Ecuador; 2.5% to USA; and 3.1% to other destinations.

15.The accumulated value of total exports to September fell 34.9%. External sales of mining goods (-46.6%) and other products (-10.2%) contributed to this result. As for the former, the negative variation was mainly due to a lower value of exports of oil (-50.4%), refined products (-59.3%), and coal (-30.6%). Among the latter, the falls in foods and beverages (-16.3%), non-metallic minerals (-21%), and vehicles (-11.4%) stand out. Exports of agricultural goods increased slightly (2.7%) thanks to the increase in coffee (13.3%).

16.In September, CIF imports in US dollars fell 22.3% on a yearly basis. This decline is associated with lower external purchases of capital goods (-24.5%), intermediate goods (-20.4%) and consumer goods (-22.9%). As for capital goods, the fall is explained by capital goods for industry (-21.7%) and transport equipment (-34.3%). Imports of intermediate goods decreased due to the fall in fuels and lubricants (-35.2%), raw materials for industry (-14.2%), and agricultural raw materials (-11.6%). Regarding consumer goods, the fall was due to the lower purchases of durable (-28.1%) and non-durable (-17.5%) goods.

17.So far this year the value of CIF imports fell 13.1% on a yearly basis. This is explained by decreases in intermediate goods (-16.2%), capital goods (-

10.3%) and consumption goods (-11.1%). The fall in intermediate goods is mainly associated with the 34.2% decline in fuels and lubricants, and of 10.2% in raw materials for industry. Within capital goods, the greatest contributions to the fall were those of capital goods for industry (-11.9%) and construction materials (-9.4%). Imports of consumer durables had a variation of -16.7%, while those of non-durable goods fell 4.8%. In volumes, so far this year, total imports have fallen 0.6% on a yearly basis due to the lower quantities in capital goods (-5.6%) and consumption goods (-4.3%), which were partially offset by higher foreign purchases of intermediate goods (5.7 %).

II. Growth, Domestic Demand, and Credit

18. According to the figures from the monthly survey of retail trade (EMCM) published by DANE, in September retail sales expanded 2.8% on a yearly basis, which reveals a slowdown *vis-à-vis* the high figures registered in August. On its part, the accumulated value for the third quarter increased 4.6% as compared to the same period in 2014. These figures suggest acceleration compared to the records of the second quarter of the year. Even so, the trend component of the series shows weakening, after the data observed the previous month.
19. Upon excluding vehicles, the annual growth in sales was around 8.1% for September and the third quarter. This segment of the retail trade continues to exhibit good performance, after showing stagnation during the first semester of the year.
20. In contrast, according to the same source, vehicle and motorcycle sales fell 18.6% on a yearly basis in September. For the accumulated value of the third quarter, the reduction was lower (about 10.5%). This figure represents a deepening of the bad behavior that this item of retail trade showed during the first semester. It should be noted that part of this performance is associated with a high base of comparison for the same period in 2014 and it is expected that the decreases extend during the fourth quarter.
21. The behavior of the number of license plates issued by the *Comité Automotor Colombiano* (Colombian Automotive Committee)¹ points at the same direction, with a 28.6% decrease in October. Additionally, by observations from the 14th *Salón del Automóvil* in Bogotá, a biennial event which took

¹ Integrated by *Asociación Nacional de Industriales* (ANDI), *Federación Nacional de Comerciantes* (FENALCO), and the firm *Econometría*.

place towards the end of November 2014, a bad performance of sales and motor vehicle records in the fourth quarter of 2015 is expected.

22. Other indicators that maintain a historically high correlation with the growth in household consumption also allow expecting a more favorable performance of this item of GDP in the third quarter. For example, in September the balance for sales according to the monthly survey of economic expectations (EMEE) of *Banco de la República* continued to show a better situation for the volume of sales than in the second quarter.
23. However, the Consumer Confidence Index (CCI) by *Fedesarrollo* suggests that household consumption would have slowed down in the third quarter. The average of the index for the period of July to September was significantly lower than those calculated for the first semester of the year and since 2001.
24. To September, unemployment indicators have stopped falling, even showing some slight increases. This is explained by a slowdown in employment, particularly that of workers with some degree of higher education. Formal employment without higher education continues to show a favorable dynamics.
25. Regarding gross fixed capital formation, excluding construction of buildings and civil works, the balance of investment expectations of the EMEE in September suggests that this aggregate did not continue to deteriorate in the third quarter.
26. On the supply side, indicators also suggest a better performance for the third quarter. Total industrial production in September grew 2.0%, higher than the figure expected by the technical staff. Excluding oil refining, the remaining industry expanded at a 2.8% rate on a yearly basis. So far this year, the sector exhibited a growth rate close to zero (0.1%). In quarterly terms, the information confirms a slight recovery of industrial activity between July and September, given that during this period production increased 1.7% after the reductions observed in the first semester of the year.
27. It should be noted that the behavior within the industry continues to be heterogeneous: while beverage processing industries (11.5%), nonmetallic mineral products manufacturing, (previously unclassified) (5.1%), production of oils and fats from vegetable and animal origin (24.6%), manufacturing of metals (12.6%), and plastic products (6.7%) show a significant dynamism, others, such as coking, oil refining, and fuel mixing (-2.1%), manufacturing of

machinery and equipment (-12.4%), and manufacturing industries of appliances and electrical equipment (-9.0%) fell.

- 28.Regarding construction, the cement production indicator increased 5.1% in September. Despite the slowdown compared to the previous month (7.9%), the third quarter reported a greater dynamism (5.3% in the 3rd quarter vs. 4.3% in the 2nd) and the accumulated value for the semester improved, expanding to a rate of 5.1% on a yearly basis. Something similar happened with shipping, which increased by 5.2% in September and 7.5% in the third quarter. On its part, although construction licenses increased 43.8% in September, the accumulated value to twelve months fell 0.3%. This implied an improvement, moving from -5.4% in the second quarter to 18.6% in the third.
- 29.According to the figures from the *Agencia Nacional de Minería* (National Mining Agency), coal production in the third quarter reached 19.9 million tons, which represents an annual growth close to zero (0.1%). So far this year, production has fallen 2.5%.
- 30.Finally, according to DANE, the monthly indicator of economic activity (ISE) posted an annual growth of 4.0% in August, which represented a 3.9% expansion of the accumulated value for the two-month period of July-August compared with the same period in 2014. This suggests acceleration in the pace of growth of GDP during the third quarter. It should be noted that the dynamics of this series does not necessarily coincide with that observed for GDP and is subject to revisions as new data is consolidated.
- 31.The figures for the fourth quarter of 2015 are scarce and do not allow for a reliable forecast of GDP growth. However, some indicators suggest a moderate behavior of household consumption, somewhat less than what would have been registered between July and September.
- 32.With figures to October, there was a slight slowdown in the pace of expansion of credit to households in nominal terms that could continue. Additionally, in October, the Consumer Confidence Index (CCI) continued at low levels, lower than the average of the series calculated since 2001.
- 33.On the supply side, the indicators available for the fourth quarter suggest that the best performance of the Colombian economy would continue. The figures of the *Federación Nacional de Cafeteros* (National Federation of Coffee Growers) recorded a coffee production of over one million bags of 60 kg (1,368,000) in October, with a yearly increase of 24.3% (compared to 14.7%

in the third quarter). So far this year to October, the accumulated growth is around 15.0%, with a production close to 11,400,000 bags.

34. In October, total energy demand increased 5.5% on a yearly basis. The trend component maintained its positive slope, and this represented an acceleration over the third quarter (4.8%). By breaking down the energy demand, it may be seen that regulated and unregulated demand grew 7.6% and 2.4%, respectively. Per region, energy demand increased substantially in the Caribbean zone (5.9%), Chocó (7.2%), Tolima (4.3%), Huila (8.3%) and Caquetá (6.4%).
35. As for oil production, although October recorded a level below one million barrels per day (999 mbd), so far this year the production is above the forecast by the Central Bank's technical staff. This implied an annual drop of 0.3% (third quarter: -1.1%).
36. On the side of the manufacturing industry, with information to October, the survey of business sentiment (EOE) by *Fedesarrollo* recorded an increase in orders and a decrease in stocks, which would reflect a better performance of the sector, while the expectations to three months fell. With all this, although the confidence indicator for the industry fell slightly in October, it maintains an upward trend with favorable levels, compared to its historical average. As for trade, the survey by *Fedesarrollo* shows that the current situation of sales for merchants continues to improve, but the prospects for six months have been more pessimistic.
37. Given the above, the forecast range for the yearly GDP growth for 2015 presented in this report remains between 2.4% and 3.4%, with 3.0% as the most likely figure, and for the third quarter between 2.3% and 3.5%.

III. Behavior of Inflation and Prices

38. In the last month, annual consumer inflation increased again, reaching 5.89%, i.e., 54 basis points (bp) higher than the result in September. The upward trend shown by this indicator for several quarters has accentuated since August. The result in October surpassed again market forecasts and those of the Economic Studies Division at *Banco de la República* (**Table 1**). Thus, the monthly variation was 0.68%, compared to the forecast by market analysts (0.39%). The increase in yearly inflation this month was led by perishable foods and by

tradable goods excluding food and regulated goods. The sub-group of regulated goods was the only that exerted downward pressures.

39. So far this year, CPI variation amounts to 5.47%. The increase in yearly inflation between December of last year and October is explained in a 52.7% by the increase in food prices, particularly those of processed foods. This is followed by the tradable component of the CPI excluding food and regulated items, whose contribution was 45.4%, and the CPI for non-tradables without food and regulated items, which contributed 13.7% of the acceleration in yearly inflation. The contribution of the CPI for regulated items was negative (-11.8%) (**Table 1**).

40. Core inflation also increased significantly in October. According to the average of the four indicators analyzed by *Banco de la República*, the figure for this month amounted to 5.11%, *vis-à-vis* 4.89% a month ago (Table 1). This has been the highest level since March 2009 (5.27%). In October, all the indicators surpassed the target range for inflation and increased versus September, being the CPI excluding primary food, fuels and utilities and the CPI excluding food and regulated items the highest levels, with 5.54% and 5.21%, respectively. On its part, the CPI excluding food closed at 4.75% (the one with the lowest rate) and core 20 at 4.94% (**Table 1**).

Table 1

Inflation to October 2015

Description	Weight	Dec 2014	Mar 2015	June 2015	Sept 2015	Oct 2015	Participation in monthly acceleration (%)	Participation in acceleration so far this year (%)
Total	100.00	3.66	4.56	4.42	5.35	5.89	100.00	100.00
Non-food Inflation	71.79	3.26	3.46	3.72	4.58	4.75	22.38	47.27
Tradables	26.00	2.03	3.46	4.17	5.90	6.42	22.16	45.41
Non-tradables	30.52	3.38	3.56	3.98	4.27	4.34	4.55	13.67
Regulated items	15.26	4.84	3.25	2.55	3.30	3.14	(4.33)	(11.81)
Food Inflation	28.21	4.69	7.37	6.20	7.30	8.80	77.62	52.73
Perishables	3.88	16.74	21.57	10.73	14.95	21.54	50.30	12.81
Processed food	16.26	2.54	5.99	6.00	6.71	7.39	18.55	32.98
Eating out	8.07	3.51	3.59	4.45	4.73	5.28	8.76	6.94
Core Inflation Indicators								
Non-food Inflation		3.26	3.46	3.72	4.58	4.75		
Core 20		3.42	3.70	4.24	4.73	4.94		
CPI excluding perishable foods, fuels and utilities		2.76	3.95	4.54	5.28	5.54		
Inflation excluding foods and regulated items		2.81	3.52	4.06	4.95	5.21		
Average of Core Inflation Indicators		3.06	3.65	4.14	4.89	5.11		

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

41. Within the CPI excluding food and regulated items, the yearly variation of the tradable segment (6.42%) has increased steadily since August 2014. This trend has accentuated in the last three months (**Table 1**). As has been stated in

previous reports, this behavior mainly reflects the depreciation of the peso against the US dollar.

42. From July 2014 until September 2015, the exchange rate of the peso accumulated a 58.4% depreciation versus the US dollar, an adjustment that has passed through to the CPI for tradables excluding food and regulated items, producing an accumulated increase of 6.7% in the same period. Thus, the pass-through of the depreciation of the peso to tradable prices (without food and regulated items) amounts to 12.0%. This elasticity, although higher than that of the two depreciation periods immediately before (2006 and 2008-2009), does not exceed the one calculated for the period 2002/2003 (32.0%). It is important to highlight that the depreciation of the peso *vis-à-vis* currencies from other countries from which consumer goods are also imported has been lower.
43. In October, the increases in the group of tradable goods included again a wide number of its items, highlighting the adjustments on vehicles, several items of personal hygiene, washing machines, refrigerators and clocks, all of which recorded annual variations exceeding 10.0%.
44. Regarding the CPI for non-tradables (excluding food and regulated items) its annual variation in September was 4.34%, somewhat higher than expected by the Economic Studies Division at *Banco de la República* and 7 bp higher than the previous month (**Table 1**). This increase was due especially to rentals, given its high weighting. The annual variation of this item increased from 3.6% to 3.7%. However, there were also increases in soccer tickets, cultural services and vehicle insurance, among others.
45. Annual variation in the group of regulated items moved from 3.30% in September to 3.14% in October (**Table 1**). This behavior is explained particularly by fuels, whose price was reduced in the past two months, allowing annual variation of this item to go from -6.2% in September to -7.3% in October. Public transport also contributed to the fall, moving from 4.6% to 3.7%. In contrast, utilities accelerated from 5.9% in September to 6.8% in October.
46. It is important to clarify that the rates of all utilities rose and could continue to do so for the rest of the year. Aqueduct increases are expected in November and December because a 3 pp accumulated variation of the total CPI was recently reached from the last tariff adjustment, which activates the indexing mechanism in the regulation formula. In energy, as a response to the potential

effects of *El Niño* on power generation, the Ministry of Mining and Energy increased the price of kilowatt/hour by \$7 pesos by the end of October. According to this source, this would be equivalent to an additional average adjustment of 1.75% in the rates, which will be introduced in the December bills. As for gas, the decline of the production, depreciation, the increasing demand for thermoelectric plants and the problems in transport have increased rates significantly, to the point that their annual adjustment in October reached 23.3%.

47. In October, annual food inflation (8.8%) increased *vis-à-vis* September (7.30%), surpassing the forecast of the Economic Studies Division at *Banco de la República*. Increases took place in all segments of this group, led by perishable foods, which were adjusted 15.0% in September compared to 21.5% in October. According to information provided by the *Sociedad Colombiana de Agricultores* (Colombian Agriculture Society, SAC), the rain deficit of the previous months due to *El Niño* has affected the productivity of several crops, including potato, thus generating a reduction of planted area and producing postponements of crops in certain regions. This would partly explain the recent price hikes for perishable goods and which could continue taking place in coming months.
48. On its part, processed foods rose from 6.7% in September to 7.4% in October, driven by items with a high imported component (cereals and oils) which would be affected by depreciation. Meals outside the home increased from 4.7% to 5.3%, which would explain the higher costs associated, especially, with the high prices of food and the readjustments of utilities.
49. Regarding non-labor costs, proxied by the PPI, annual inflation for the producer of domestic supply (produced and consumed plus imported) closed at 8.7% in the last month compared to 8.2% in September. This behavior is explained by the fall of the yearly adjustment of the imported component (from 22.8% in September to 19.0% in October), at the same time related to the appreciation of the peso in the last month. In contrast, the annual variation of the local component of the PPI (4.8%) grew 58 bp *vis-à-vis* September.
50. With information to September and October, wages continued exhibiting yearly adjustments which were consistent with the inflation target range. Those for heavy construction (3.8%) and housing (4.2%) showed no significant changes during October. Retail trade, on its part, exhibited a slight slowdown from about 4.0% in August to 3.7% in September.

51. Inflation expectations to December this year obtained from the monthly survey to financial analysts increased significantly between October (5.58%) and November (6.24%). Inflation expectations to twelve months obtained from the same survey also rose from 4.12% in October to 4.41% in November, while that expected to twenty-four months stepped from 3.46% to 3.55%. On average, so far this year to November 24², versus the average data from October, implicit inflation derived from sovereign bonds in pesos (TES) and Real Value Unit (RVU) (namely Break-even Inflation, BEI) have increased for 2, 3, 5 and 10 years (25 bp, 21 bp, 20 bp, and 31 bp, respectively). Thus, BEI to 2, 3, 5 and 10 years posted at 4.77%, 4.67%, 4.61%, and 4.71%, respectively.³

² According to the last meeting of the Board of Directors and with data up to November 24, BEI for 2, 3, 5 and 10 years has presented variations of +10 bp, -3 bp, -9 bp and + 10 bp, respectively. Thus, Break-Even Inflation (BEI) on November 24 posted at 4.73%, 4.60%, 4.55%, and 4.73%, respectively.

³ These indicators of inflation expectations may be distorted by liquidity premia for fixed-rate and RVU securities, and the risk premium for inflation.