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Banco de la República

Monetary Policy Report

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Monetary Policy Report

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I. External Context and Balance of Payments

1. The data available suggest that growth of the country's trading partners would have remained very modest, even more than forecast in the previous quarterly Inflation Report.

2. Similarly, the World Trade Organization expects lower global trade growth for 2016 and 2017, with respect to its April forecast.

3. In the United States, to August, the unemployment rate stood at 4.9%. The figures for job creation remain relatively high. However, retail sales, industrial production, and business confidence do not suggest an acceleration of economic activity in that month, which suggests a lower growth in the second half of the year than the one considered in the previous quarterly report.

4. In August, core inflation was 2.3%, while headline inflation remains close to 1.0%, below the Fed's target (2.0%).

5. In this context, the Open Market Committee of the Federal Reserve (FOMC) at its September session decided to leave the benchmark interest rates unaltered within a 0.25% to 0.5% range. The FED fund futures prices suggest that the probability of the Fed keeping the range of interest rates unaltered to December is 48%, while the probability of placing it at 0.5% to 0.75% is 48.1%.

6. As for the euro zone, the monthly retail sales indicator to July and the consumer confidence index to September suggest that consumption is gaining momentum. However, the industrial production index and the PMI (to July and September, respectively) indicate that industrial production continues to grow very slowly. On the other hand, in August, annual inflation remained stable at 0.2%, while core inflation stood at 0.8% (0.9% in July). In this context, the European Central Bank (ECB) kept its monetary stimulus policies unaltered.

7. In China, the gradual transition to a growth model based on household consumption continues, for which growth of investment continues to be moderate. Although the data are close to the GDP goals for the Chinese

government, there are concerns regarding a sharp deceleration and possible financial instability.

8. In Latin America, the figures available for GDP in the second quarter are lower than those reported for the first quarter, except for Mexico and Brazil. In Ecuador, data to march show a deepening of the recession. Although there are no recent figures, Venezuela is expected to continue exhibiting negative output growth rates. As for inflation, Chile and Peru continue with a downward trend.

9. In September, the volatility of the financial markets remained low, as did the interest rates of bonds from developed economies. Stock indices presented slight reductions during the month. As for Latin America, credit default swaps (CDS) exhibited some increases, mainly for Brazil and Mexico, while exchange rates remained relatively stable (except for Mexico, which depreciated).

10. To 27 September, the price of oil remained relatively stable during the month. Inventories have declined *vis-à-vis* the levels observed at the beginning of the year; however, they remain high. On the supply side, it is worth mentioning that production cuts persist in Libya and Nigeria.

11. However, the OPEC, in its meeting of 28 September, reached a preliminary agreement to reduce production. The details of this would be specified at the November meeting.

12. The prices of other products exported by Colombia such as coal, coffee, and nickel remain at levels higher than those observed at the beginning of the year. In contrast, imported foods such as corn and wheat quote at lower prices than in the first months of 2016. Hence, the indicator for Colombia's terms of trade would have continued to recover, although it would still be low.

a. Exports and Imports

13. In July, the value of exports in US dollars registered a yearly 27.3% fall due to setbacks in external sales for all groups of products. Mining products (-19.9%) and the group of other goods (-37.3%) contributed the most to the reduction. To date, exports have registered a 25.9% decrease, mainly because of sales of mining goods (-34.9) **(Table 1).**

14. So far this year, the price index for total exports registered a significant drop (-22.2%), while the volume index has fallen moderately (-5.0%). This would indicate that the value of exports continues falling, mainly as a result of the reductions in prices, from which the most significant is that of mining products (-28.4% year on year for the first seven months).

15. According to the preview for foreign trade by DIAN, exports excluding oil grew 18.4% on a yearly basis in August (according to this source, they would have fallen 27.3% in July).

16. In July, CIF imports in US dollars recorded an annual 32.5% drop due to setbacks in external purchases in all groups, with that of capital goods as the most important (-40.0%). So far this year, imports have fallen 22.7% **(Table 2)**.

17. In the period from January to July, the price index for total imports registered a 14.2% fall, while the volume index has fallen 9.9%. This would show that imports drop by a combined effect of reductions in prices and quantities.

18. According to the foreign trade preview by DIAN, CIF imports in August recorded a 5.6% yearly fall.

Table 1: Behavior of Exports in US dollars

July 2016			
	Annual Variation	Main contributing items:	
		Item	Annual variation of the items
Total	-27.3%		
Agricultural goods	-34.0%	Coffee	-46.2%
		Banana	-32.5%
Mining goods	-19.9%	Oil	-28.0%
		Coal	-15.8%
Other exports*	-37.3%	Chemical products	-34.2%
		Foods, beverages, and tobacco, excluding coffee	-38.8%
Accumulated value for January-July 2016			
Total	-25.9%		
Agricultural goods	-6.7%	Coffee	-17.3%
Mining goods	-34.9%	Oil	-47.7%
		Coal	-18.3%
Other exports*	-15.7%	Chemical products	-19.2%
		Graphic and Editorial Arts (paper, cardboard and their products)	-37.1%

* All destinations in this group fell; the 38.1% reduction towards ALADI (excluding Venezuela and Ecuador), 18.2% towards the United States,

and 42.5% toward the rest of the world (excluding the US, ALADI, the European Union, and Asia) stand out.
Source: DANE

Table 2: Behavior of Imports in US dollars

July 2016			
	Annual Variation	Main contributing items:	
		Item	Annual variation of the
Total	-32.5%		
Capital Goods	-40.0%	Transportation equipment	-69.4%
		Industrial machinery	-48.9%
Raw materials	-30.2%	Chemical and Pharmaceutical products	-25.5%
		Fuels	-54.7%
Consumer Goods	-25.4%	Vehicles for private use	-33.4%
		Pharmaceutical products and toiletries	-28.0%
Accumulated Value for January-July 2016			
Total	-22.7%		
Capital Goods	-32.8%	Transport equipment	-66.1%
		Industrial machinery	-28.9%
Raw materials	-17.3%	Fuels	-29.3%
		Mining Products (for industry)	-22.4%
		Chemical and Pharmaceutical products	-14.6%
Consumer Goods	-17.4%	Vehicles for private use	-27.7%
		Pharmaceutical products and toiletries	-11.3%

Source: DANE

19. On the other hand, the current account deficit in the first half of 2016 stood at USD 6,284 million (m), lower by USD 3,233 m to that from a year ago. As a percentage of GDP, the deficit was 4.8%, lower than the 6.3% observed in the first half of 2015. The reduction is explained by the lower deficit in factor income (US$1,531 m) and in the balance of services (USD 814 m). The smaller trade deficit of goods (US$506 m) and the higher income from transfers (USD 383 m) also contributed to this drop.

20. Regarding the financial account, inflows of foreign capital by USD 13,451 m were recorded during the same period, of which 62% (USD 8,354 m) was due to FDI, 19% (USD 2,527 m) to issuance of bonds on international markets, 12% (USD 1,663 m) to portfolio investment in the local market, and the remainder to loans and other external credits. It is estimated that the country registered capital outflows by residents for USD 6,961 m in the same period. These resources were allocated mainly for the acquisition of financial assets abroad.

II. Growth, Domestic Demand and Credit

21. The information available suggests that the Colombian economy continued to decelerate during the third quarter of 2016. Particularly, the supply shocks that took place towards the end of June and throughout July in the transport sector would have had a real impact on other items of the GDP.

22. Private consumption would have recorded additional slowdowns, while gross capital formation would have continued to contract. Real exports would have expanded at a pace similar to that of the second quarter, while imports would have fallen significantly, akin to the performance of the items of domestic demand with a significant imported component.

23. According to the Monthly Survey of Retail trade (EMCM by its acronym in Spanish) from DANE, in July, total retail sales (excluding fuels) dropped 2.0% annually, a figure lower than the one registered for the aggregate of the second quarter (1.2%). Excluding vehicle sales, the remaining aggregate grew 3.2% on a yearly basis. Although this suggests an acceleration compared to the records in May (0.1%) and June (0.4%), it is due to a low basis of comparison. Also, vehicle sales registered an annual contraction of 26.5%, significantly deeper than in the second quarter (-2.8%).

24. License plate registers reported by the Colombian Committee Automotive (CAC by its acronym in Spanish) for the two-month period of July-August exhibited a -19.8% fall, greater than the -9.8% fall in the second quarter. It should be noted that August partly offset the sharp fall in July (-34.1%) caused to some extent by the trucking strike.

25. In July, the balance of sales of the Monthly Survey of Economic Expectations (EMEE by its acronym in Spanish) of *Banco de la República* registered a lower level than the one observed during the second quarter of 2016.

26. On the contrary, in August the Consumer Confidence Index (ICC by its acronym in Spanish) recovered slightly compared to the levels of the previous months, although the series remains significantly below the average calculated since November 2001.

27. In July, the unemployment rate showed increases in all geographic domains, except in rural areas. The increase is explained because the employment rate fell this time, while the participation rate remained stable. The seasonally

adjusted series of employed individuals shows stagnation for the national total and the thirteen areas.

28. On the other hand, in August, household loans in nominal terms recorded an increase similar to that of the previous months. However, interest rates, both nominal and real, continue to increase in the margin.

29. Regarding the gross capital formation other than construction of buildings and civil works, in July the balance of investment expectations of the EMEE posted a slight decrease compared to the previous month. Besides, according to the information of the foreign trade bulletin of DIAN to August, imports of capital goods (in constant pesos) continued to fall at a pace similar as that of the second quarter.

30. The figures for foreign trade in US dollars from DANE (to July) and the DIAN's bulletin (to August) converted to constant pesos suggest that the correction of the trade deficit would have continued in the third quarter. Above all, this would be due to a significant drop in imports, consistent with the forecast for the demand of machinery and equipment, transport equipment, and durable consumer goods.

31. On the supply side, the few indicators available for the third quarter also show a deterioration of economic activity compared to the first half of the year.

32. In July, according to the Monthly Manufacturing Survey by DANE, industrial production showed a significant contraction of 6.2%, a figure lower-than-expected by the technical staff at the Central Bank. Excluding oil refining, the remaining industries decreased 9.7%. Refining increased 11.8%. This year to date, the industry expanded at an annual rate of 3.9%; excluding refining, it was 0.9%.

33. In addition to the effect associated with a lower number of working days (2 more holidays as compared with the same month in 2015), according to DANE and the business opinion survey by the ANDI, the 46-day trucking strike significantly affected the performance of the sector. Industrialists pointed out problems of shortage of drivers and trucks, increase in the cost of storage, freight charges, and in the inventories of finished products, among other factors.

34. Contrastingly, with information to August, the indicator of orders, stocks and production expectations of industry to three months by Fedesarrollo showed an improvement versus July and the average for the second quarter. Besides, the demand for industrial energy showed a better performance (stepping from -11.1% in July to +2.7% in August). This suggests that after the shock associated with the trucking strike the industry would have recovered part of the production lost in July.

35. As for construction, cement production in July registered a significant contraction (17.6%), and the accumulated to six months exhibited a 4.1% decrease. The trend component shows a negative slope. Something similar occurs with construction licenses, which showed deterioration in July, falling 29.4% (-34.2% in the area approved for non-housing destinations and -27.4% in the area approved for housing).

36. In August, oil production posted at 827 thousand barrels per day (a 14.4% fall). For the two-month period of July-August, the decline was 12.6% on a yearly basis. So far this year, oil extraction decreased 10.2%, more than expected in the previous quarterly report.

37. In August, coffee production stood at 1,189,000 bags, exhibiting a 5.9% yearly reduction. The two-month period of July-August exhibited a significant setback (moving down from 2.0% in the second quarter to -15.3%). Year-to-date, the sector dropped 1.6%.

III. Behavior of Inflation and Prices

38. In August, annual consumer inflation presented a break in the upward trend observed for several quarters, standing at 8.10% on a yearly basis (87 basis points less than the figure for the previous month) **(Table 3)**. Inflation for the year to date amounted to 5.31%, while the monthly variation was negative (-0.32%) and lower than forecast by the market average (0.18%) and by the Central Bank.

Table 3

Headline and Core Inflation - to August 2016

Description	Weight	Dec 2015	Mar 2016	Jun 2016	Jul 2016	Aug 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**	**8.97**	**8.10**	**100.00**	**100.00**
Non-food inflation	**71.79**	**5.17**	**6.20**	**6.31**	**6.26**	**6.10**	**13.72**	**48.27**
Tradables	26.00	7.09	7.38	7.90	7.87	7.53	**8.89**	8.19
Non-tradables	30.52	4.21	4.83	4.97	5.01	5.05	**(0.69)**	19.20
Regulated items	15.26	4.28	7.24	6.71	6.40	6.10	**5.52**	20.89
Food inflation	**28.21**	**10.85**	**12.35**	**14.28**	**15.71**	**13.06**	**86.28**	**51.73**
Perishables	3.88	26.03	27.09	34.94	39.27	21.27	87.22	(10.60)
Processed food	16.26	9.62	10.83	12.09	13.33	13.07	3.99	42.18
Eating out	8.07	5.95	7.53	8.11	8.50	9.00	(4.93)	20.15
Core inflation indicators								
Non-food inflation		5.17	6.20	6.31	6.26	6.10		
Core 20		5.22	6.48	6.82	7.03	7.07		
CPI excluding perishable foods, fuel and utilities		5.93	6.57	6.77	6.92	6.97		
CPI excluding food and regulated items		5.42	5.91	6.20	6.22	6.10		
Average of core inflation indicators		**5.43**	**6.29**	**6.52**	**6.61**	**6.56**		

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

39. The decrease in annual inflation in August was largely explained by the reduction in food prices, particularly perishables. There were also declines in the subgroups of regulated and tradable items (excluding food and regulated).

40. Core inflation, measured by the average of the four indicators monitored by the Central Bank, lowered from 6.61% in June to 6.56% in July. The behavior of the diverse indicators was mixed: Core 20 increased somewhat (7.07%, the highest level), as did the CPI excluding perishable food items, fuels and utilities (6.97%), whereas the CPI excluding food and regulated items lowered (6.10%), as well as the CPI excluding food (6.10%).

41. Within the CPI excluding food, the non-tradable component was the only one that rose slightly (from 5.01% in July to 5.05% in August). In this subgroup, the annual CPI variation for leases rose slightly from 4.1% to 4.2%; something similar happened with the more indexed items, which went from 6.1% to 6.2%.

42. The annual CPI variation for regulated items (6.10%) declined again (30 bp), thanks to a decreasing yearly adjustment in public utilities (10.6% versus 11.9% in July), explained by water and sewerage rates (9.3% to 5.5%). Although the enforcement of the new regulatory framework for rates last month generated increases in July in several cities, it also enabled a reduction of the rates in Bogotá (-12.6% in August). Gas also presented a decrease in its annual variation (from 20.0% to 14.0%). The rates for electricity exerted upward pressures, since its annual variation increased (from 11.0% to 13.2%). The same happened with fuels, whose annual variation rose from -5.2% to -4.9%, and with public transport, which went from 5.0% to 5.5%.

43. Further declines in rates of gas for the coming months are not to be ruled out, considering that the CREG could compel traders to reduce them because the apparent transfer of the distribution overruns to their customers is not in the regulations. On the contrary, an increase in taxi rates is expected in Bogotá.

44. For tradables excluding food and regulated items the annual CPI variation fell for the second consecutive month, standing at 7.53% (7.87% in July). The slowdown in this indicator suggests that the effects of the accumulated depreciation are beginning to dissolve. The impact that the adjustment of the benchmark interest rate would have had on demand must be added to this.

45. Food CPI, which explains most of the fall of yearly consumer inflation this month, went from 15.71% in July to 13.06% in August. Much of this decline is explained by the decrease in the prices of perishable food, with an annual variation that went from 39.27% to 21.27%. The stronger reductions were those of potato and several vegetables (carrot, tomato, and onion).

46. For processed food, the annual CPI fell slightly between July (13.33%) and August (13.07%), due to the lower adjustment in the price of beef (24.4% to 23.2%). In spite of this, the price of meat still exhibits high levels, mainly due to the continuation of the cattle-retention phase, which would be extended a few months more, as reported by the cattle-raising guild.

47. It should be noted that food supply increased significantly in August and so far in September, once cargo transport was restored on 22 July, after the trucking strike. According to preliminary information obtained from Sipsa, food prices would have continued to fall in September.

48. Despite the decline in the prices of perishable and processed food, in August the annual CPI variation for eating-out items stood at 9.0%, i.e., 50 bp more than the record for the previous month.

49. On the other hand, the upward pressures of non-labor costs moderated in August. Yearly variation of the PPI for domestic supply (domestically produced and consumed items plus imported goods) lowered significantly from 8.38% in July to 4.89% in August. The decrease was explained both by the imported component (which went from 5.81% in July to 0.53% in August), and by goods produced and consumed locally (from 9.51% in July to 6.92%).

50. Regarding labor costs, with information to July, the wage adjustment for retail rose from 6.9% in the second quarter to 7.5%. On the contrary, the one for industry declined from 6.5% to 5.0%. With information to August, the wages of heavy construction and housing remained relatively stable.

51. Inflation expectations to December 2016, obtained from the monthly survey to financial analysts at the beginning of September lowered from 6.77% in August to 6.26% in September; those to 12 months lowered from 4.55% to 4.35%, and those to 24 months from 3.72% to 3.61%. Finally, on average during the month to September 28, compared to the average for August, Break-even Inflation expectations embedded in government bonds (TES) in pesos and UVR decreased 78, 62, and 43 bp for 2, 3 and 5 years, posting at 3.57%, 3.45%, and 3.37%, respectively.