PUBLIC VERSION

Working Papers from the

Board of Directors

Banco de la República

Monetary Policy Report

PUBLIC VERSION

Working Papers from the

Board of Directors

Banco de la República

Monetary Policy Report

Economic Studies Division

APRIL

2017

I. External Context and Balance of Payments

1. The information available would confirm the growth dynamics of the trading partners expected in the past Inflation Report, characterized by weak growth, although better than last year. A downward revision would be considered only for the forecasts for Peru and Brazil.
2. In the United States, growth continued to be based on domestic demand, particularly consumption. Although the unemployment rate is low and close to its non-inflationary level, wage pressures that could be transmitted to prices have not been observed yet. On the other hand, headline and core inflation fell from 2.4% and 2.0% in March to 2.2% and 1.9% in April, respectively. Analysts continue to anticipate headline inflation to post above the Fed's long-term target (2.0%) for the remainder of 2017 and during 2018.
3. Data from the euro zone show higher levels of consumer confidence in April and of industry in March. Inflation increased and stood at 1.9% in April, close to the European Central Bank's target.
4. Regarding the Chinese economy, on May 24, Moody's lowered the credit rating of its sovereign debt due to concerns about their level of indebtedness.
5. In Latin America, figures of economic activity available to March exhibited deterioration in Peru and Chile, explained by the strong supply shocks that these two economies are facing. In Brazil, although there was some recovery, the recent political situation could affect future results significantly. Inflation has continued its decline in the region, except in Mexico, where a significant acceleration has taken place along 2017. This case would be associated with the accumulated depreciation of the Mexican peso and the rise in fuel prices.
6. The currencies of the region continue to exhibit a trend towards appreciation. Brazil was the exception, where a depreciation related to the increase in political uncertainty was observed last week.
7. CDS in Latin America have continued to show a slight downward trend. Once again, Brazil was the exception, where it increased due to the political scandal.
8. Colombia's terms of trade to March increased thanks to the increase in the prices of its main export products. Much of this trend would continue should oil remain at its current levels, which appears to be the case, considering the extension of the agreement on the limits to production until March 2018 announced by the OPEC.

Exports (**Table 1**).

9. In March, the value of exports in US dollars registered a yearly 37.9% increase due to the behavior of all groups, particularly mining goods, which increased 57.9% on a yearly basis). Recovery of the external sales of the group of others

(associated with manufactured goods) stands out, which expanded 7.9% on a yearly basis (**Table 1**).

Table 1: Behavior of Exports in US dollars

March 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	37.9%			
Agricultural goods	42.3% [7.3]	Coffee	64.3%	4.8
		Flowers	25.5%	1.3
Mining goods	57.9% [27.9]	Coal	124.6%	14.7
		Oil	25.6%	6.5
Other exports*	7.9% [2.7]	Chemical Products	17.6%	1.5
		Non-metal minerals and basic metals	37.6%	0.9
Accumulated value for January-March 2017				
Total Exports	31.4%			
Agricultural goods	24.6% [4.1]	Coffee	41.6%	3.2
		Banana	15.8%	0.5
Mining goods	57.0% [27.8]	Oil	45.4%	11.6
		Coal	82.7%	10.6
Other exports	-1.4% [-0.5]	Foods, beverages, and tobacco, excluding coffee	-12.1%	-0.9
		Textile products	-14.5%	-0.2

* Within this group, the destinations which contributed the most to growth were rest from ALADI, Asia, and Ecuador, with 34.0%, 57.5%, and 11.4% annual increases, respectively. The United States also grew annually (5.7%), and Venezuela continues exhibiting annual declines (61.4% in March).
Source: DANE

10. So far this year, the value of total exports grew 31.4%, mainly responding to the 57% increase in the external sales of mining goods. This behavior is due to the increase in prices (36.2%), given that the amounts decreased (-3.3%). The most significant improvements in prices took place in mining assets (61.4% annually in the accumulated value to March).
11. According to the preview for foreign trade by DIAN, in April, exports excluding oil and its derivatives decreased 4.8% on a yearly basis (according to this source, they had grown 37.7% in March; however, the increase reported later by DANE was 40.5%).

Imports (**Table 2**).

12. In March, the US dollar value of CIF imports showed an annual growth of 14.8%, to which all groups contributed, with purchases of capital goods

standing out. As for consumer goods, non-durable goods fell 1.1%, while durables increased 15.6% (**Table 2**).

13. So far this year, the value of total imports increased 6.9%, quantities grew 5.8%, and prices 1.0%.
14. According to the preview for foreign trade by DIAN, CIF imports recorded an annual 1.6% growth in April. (According to this source, they had grown 16.2% in March; however, the figure reported later by DANE was 14.8%).

Table 2: Behavior of Imports in US dollars

	Annual Variation [Contribution]	Item	Annual variation of the item	Contribution to annual variation
March 2017		Main contributing items to annual variation, in the same direction:		
Total Imports	14.8%			
Capital Goods	30.4%	Transport equipment	240.4%	4.8
	[8.3]	Other fixed equipment for industry	31.3%	1.4
Raw materials	10.4%	Food products for industry	59.8%	3.2
	[5.0]	Mining products for industry	25.0%	2.0
Consumer Goods		**Non durable consumption goods**	**-1.1%**	**-0.2**
		Food products	-4.5%	-0.2
	6.0%	Tobacco	-48.1%	-0.1
	[1.5]	**Durable consumption goods**	**15.6%**	**1.6**
		Private transportation vehicles	28.9%	1.5
Accumulated Value for January-March 2017				
Total Imports	6.9%			
Capital Goods	6.4%	Other fixed equipment for industry	14.7%	0.8
	[1.9]	Parts and accessories for transport equipment	18.5%	0.7
Raw materials	6.8%	Food products for industry	24.0%	1.4
	[3.2]	Chemical and pharmaceutical products	7.6%	1.1
Consumer Goods		**Non durable consumption goods**	**1.5%**	**0.2**
		Food products	3.9%	0.2
	7.6%	Tobacco	-77.3%	-0.1
	[1.8]	**Durable consumption goods**	**15.4%**	**1.6**
		Private transportation vehicles	23.8%	1.3

Source: DANE

II. Growth, Domestic Demand, and Credit

15. The recent publication of the GDP on the supply side shows that the Colombian economy slowed down in the first quarter of 2017, growing 1.1% on a yearly basis, compared to 1.6% in the fourth quarter of 2016. This figure was slightly lower than expected by the technical staff in the previous quarterly report (1.3%). In quarterly terms, economic activity showed a 0.2% contraction (-0.9% annualized).
16. Per branch of activity, the sectors that grew most in that quarter were agriculture and financial services. Contrastingly, mining, construction, utilities (energy, gas, water) and transport exhibited contractions (**Table 3**). It is worth noting that the growth of construction of buildings and civil works was lower than expected by the Central Bank. The forecasts of the technical staff for the whole year suppose a significant dynamism in construction, particularly in civil works.
17. On the side of expenditure, the DANE will publish the figures on 26 May. With information to March, retail sales figures suggest that private consumption slowed down *vis-à-vis* the records for the end of 2016 (-1.7% fotr the aggergate for the first quarter vs. 4.9% in the last quarter of 2016); public consumption would have been recovered. Investment would have accelerated, although with an uneven behavior: investment in capital goods would have improved (according to the figures for imports of this type of goods in US dollars), while construction of buildings would fall (according to the data on the supply side).
18. With all of the above, domestic demand would have exhibited a better behavior than in the most recent quarters.

Table 3

Real annual GDP growth per economic activity

Branch of activity	2015	2016				2016	2017
	Whole Year	1st Q	2nd Q	3rd Q	4th Q	Whole Year	1st Q
Farming, forestry, hunting and fishing	3.3%	0.0%	0.4%	-0.5%	2.0%	**0.5%**	**7.7%**
Mining and quarrying	0.6%	-4.7%	-6.9%	-6.5%	-8.2%	**-6.5%**	**-9.4%**
Manufacturing	1.2%	4.3%	5.1%	1.5%	1.0%	**3.0%**	**0.3%**
Electricity, gas and water	2.9%	2.9%	-0.7%	-1.3%	-0.5%	**0.1%**	**-0.6%**
Construction	3.9%	5.3%	0.8%	6.8%	3.5%	**4.1%**	**-1.4%**
Buildings	2.1%	10.9%	2.8%	11.0%	0.9%	**6.0%**	**-7.1%**
Civil works	5.4%	0.4%	-0.4%	1.9%	5.1%	**2.4%**	**3.5%**
Retail, repairs, restaurants, and hotels	4.1%	2.8%	1.9%	0.8%	1.6%	**1.8%**	**-0.5%**
Transportation, warehousing, and communications	1.4%	0.9%	0.2%	-1.5%	-0.1%	**-0.1%**	**-0.3%**
Financial, real estate, and corporate services	4.3%	5.0%	5.4%	4.4%	5.0%	**5.0%**	**4.4%**
Social, community, and personal services	2.9%	3.5%	3.2%	1.3%	0.9%	**2.2%**	**2.2%**
Subtotal value added	3.0%	2.7%	2.2%	1.3%	1.5%	**1.9%**	**1.0%**
Taxes minus subsidies	4.0%	1.3%	4.1%	0.4%	2.8%	**2.2%**	**2.7%**
GROSS DOMESTIC PRODUCT	3.1%	2.6%	2.4%	1.2%	1.6%	**2.0%**	**1.1%**

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

19. Information on the performance of the economy for the second quarter is still scarce, but suggests there would be a low growth figure again. The technical staff continues to anticipate that recovery of the output would take place mainly in the second half of the year.
20. On the supply side, in April, oil production stood at 857 mdb, which represented a 6.2% yearly contraction. In the same month, energy demand grew 1.0% annually (1.9% for the regulated component and -0.8% for non-regulated). As for industry, energy demand fell 3.1%.
21. According to figures from the National Federation of Coffee Growers, coffee production in April was 834,000 sacks, which meant an annual 20% contraction, contrasting with the average observed during the first quarter (around 13%). So far this year, the production has grown 4.8%, akin to the expectations for the whole year (a level of 14.8 million bags, which implies an annual 4.0% growth rate).
22. Regarding the indicators of demand, the consumer confidence index (ICC) published by Fedesarrollo increased in April, but remained at low levels.
23. Labor market indicators do not support a dynamic household consumption. Discounting the seasonal effect, with figures to March, the unemployment rate continued to show an upward trend for the national total and the thirteen areas. In the latter, the number of non-salaried workers has increased in recent months, while that of salaried workers has declined (seasonally adjusted).
24. Consumption of durable goods would continue registering a mediocre behavior. According to the April figures published by ANDI and Fenalco, vehicle registrations fell 15.8% *vis-à-vis* the same month in 2016. The trend component of this series continues exhibiting deterioration. Besides, this setback occurred for vehicles both for private use (-18.2%), and for commercial use (-13.0%).
25. The behavior of household spending has been taking place along with a nominal growth of consumer credit close to 13.5%, similar to the one observed in the last months. Mortgages also increase at a pace close to 13% on a yearly basis (nominal).
26. Considering all this, the technical staff forecasts that private consumption will continue to show a lack of dynamism in the second quarter.
27. Regarding gross capital formation, the figures for capital goods imports published in the foreign trade news bulletin from the DIAN to April (carried to constant pesos), suggest that investment other than that for construction of buildings and civil works would have ceased to fall. Should this dynamics continue, this component of GDP would grow in the second quarter of the year.
28. Finally, regarding foreign trade to April, the preview of the DIAN suggests that both exports and imports in constant pesos would have grown. In the first case, foreign sales of coal, bananas, coffee, and gold would continue contributing to

the item. In the second case, better performances of the purchases of capital goods and raw materials would be observed.

29. All this suggests that some downside risks referred to in previous reports would be materializing. However, the technical staff at *Banco de la República* maintains its 1.8% forecast for GDP growth in 2017, within a range of 0.8% and 2.6%, awaiting for new information that may clarify the trends in the economy.

III. Behavior of Inflation and Prices

30. Unlike previous months, in April, annual consumer inflation remained relatively stable versus the figures for March, standing at 4.66% (it decreased 3 bp) (**Table 4**). It should be noted that annual inflation reached a recent peak in July 2016, when it posted at 8.97%.
31. The monthly variation of the CPI was 0.47%, which is higher than market estimations (0.38%). To April, the CPI has accumulated a 3.0% increase.
32. As has been happening since last August, the higher downward pressure came from the food CPI. Tradables and non-tradable (excluding food and regulated items) also contributed to the decline in inflation, although to a lesser extent. On the contrary, the annual CPI variation of regulated items increased significantly, and offset the decline in other groups.
33. Core inflation, measured as the average of the four indicators monitored by the Central Bank, also remained relatively stable, moving from 5.55% in March to 5.52% in April. In the last five months, this average has not exhibited significant changes, fluctuating between 5.5% and 5.6%. Last month, three of the four indicators lowered compared to the March data: Core 20 (from 6.01% to 5.84%), the CPI excluding food and regulated items (from 5.44% to 5.28%), and the CPI excluding primary food, fuel, and public utilities (from 5.61% to 5.37%). Only the non-food CPI increased (from 5.13% to 5.60%) mainly by the weight of regulated items in its calculation (**Table 4**).

Table 4

Headline and Core Inflation to April 2017

Description	Weight	Dec 2016	Jan 2017	Feb 2017	Mar 2017	Apr 2017
Headline inflation	**100.00**	**5.75**	**5.47**	**5.18**	**4.69**	**4.66**
Non-food inflation	**71.79**	**5.14**	**5.26**	**5.17**	**5.13**	**5.60**
Tradables	26.00	5.31	5.37	5.75	5.59	5.35
Non-tradables	30.52	4.85	4.83	5.06	5.33	5.22
Regulated items	15.26	5.44	5.93	4.55	4.05	6.75
Food inflation	**28.21**	**7.22**	**5.97**	**5.21**	**3.65**	**2.49**
Perishables	3.88	(6.63)	(10.15)	(9.60)	(13.09)	(14.47)
Processed food	16.26	10.74	9.38	7.69	6.28	5.12
Eating out	8.07	8.54	9.26	9.31	8.94	8.08
Core inflation indicators						
Non-food inflation		5.14	5.26	5.17	5.13	5.60
Core 20		6.18	6.18	6.03	6.01	5.84
CPI excluding perishable foods, fuel and utilities		6.03	5.95	5.74	5.61	5.37
CPI excluding food and regulated items		5.05	5.06	5.35	5.44	5.28
Average of core inflation indicators		5.60	5.61	5.58	5.55	5.52

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

34. Within the CPI excluding food, the annual variation in the group of tradables (excluding food and regulated items) lowered from 5.59% in March to 5.35% in April. This completed two months of reduction of this indicator, which suggests, among other things, that the effect of the increase in indirect taxes (due to the tax reform of December 2016 and the Liquor Act) would have already been transmitted to a large extent to the level of consumer prices. As known, the bulk of the impact of higher taxes falls on this group, whose prices accelerated in January and February, despite the scarce pressure from the exchange rate and demand.
35. Regarding non-tradable inflation (excluding food and regulated items), its annual variation lowered from 5.33% in March to 5.22% in April. Leases contributed to this fall most of all, which slowed down in April for the first time so far this year (from 4.48% in March to 4.28% in April). Other components of the non-tradable group such as education and health services, whose prices tend to have a high response to wage adjustments and which are also highly indexed, continued to exhibit a high annual variation, close to or higher than 7.0%, although somewhat lower than in March.
36. As for regulated items, annual CPI variation rose from 4.05% in March to 6.75% in April. This behavior is explained by a low basis for comparison in the same month last year for energy (due to the decreases in the rates in Bogotá), the 10% adjustment of the Transmilenio fares, and the increase in the price of fuels. The increase in aqueduct rates added to this.
37. As for food, the normalization process of supply and prices continued in April, as was expected after last year's weather shock. Increased stability of the

exchange rate and few pressures from international prices of agricultural raw materials imported by the country have also contributed to this. Thus, the annual CPI variation of food lowered from 3.65% in March to 2.49% in the last month, driven by the lower adjustments or declines in the prices of perishable foods and processed or semi processed foods such as beef. Additionally, the annual variation of meals outside the home, which exerted upward pressures until February, fell for the second consecutive month in April (to 8.08%) (**Table 4**).

38. Non-labor costs picked up in April the descending path they were showing since the middle of last year. Hence, annual variation of the PPI for domestic supply (domestically produced and consumed items plus imported goods) rose from 0.55% in March to 0.39% in April.
39. As for labor costs, the latest information available for wages shows that they have continued to grow at relatively high rates *vis-à-vis* the inflation target (3.0%), although in some cases at a lower pace than in previous months. Particularly, wages in the manufacturing industry adjusted to an annual 7.1% rate in March, those for retail to 5.8%, and those for housing construction in April to 6.0%. Salary costs would be generating upward pressure on certain segments of the CPI, especially on services, despite the labor market relative slack.
40. According to the latest monthly survey to financial analysts by the Central Bank (applied at the beginning of May), inflation expectations remained relatively stable compared to those obtained in the previous month. Particularly, the inflation figure expected for December 2017 increased from 4.39% in April to 4.45% in May, as did the expectations to 12 months (although to a lesser extent, moving from 3.65% to 3.67%). On the contrary, inflation expectations to 24 months did not change significantly (from 3.40% to 3.39%).
41. Inflation embedded in public debt bonds (*Breakeven inflation*, *BEI*) extracted from the TES denominated in pesos and UVR to May 24 is at 3.23% to 2 years and 3.27% to 3 and 5 years. Compared to the average for April, average BEI lowered 2 bp for 2 years, while it increased 7 bp and 12 bp for 3 and 5 years, respectively.
42. Finally, using the Forward Break-Even Inflation (FBEI) curve, the estimation of annual inflation for 2017 is 5.24% (obtained by adding the accumulated inflation observed to the inflation expectations for the remainder of the year). For 2018, 2019 and 2020 it corresponds to 3.36%, 3.32% and 3.27%, respectively.