

# INTRODUCTION

In the Reports of the Board of Directors of *Banco de la República* to the Congress submitted in 2015 and March 2016, a detailed analysis was made with regard to the consequences of the intense terms-of-trade-shock on the Colombian economy. Later, the economy had to suffer further shocks like the so-called phenomenon of El Niño and the increase of the interest rate in the United States that made the environment even more complex and rose the degree of difficulty in the monetary policy decision-making process. Economic growth slowdown, an increasing inflation, and the widening of the current account deficit in the balance of payments in an atmosphere of high uncertainty pose a major challenge to macroeconomic policy.

In an adverse and volatile scenario, the Colombian economy has been moving ahead under a gradual and orderly adjustment process as supported by sound economic foundations and a proper policy framework. The economic authorities' timely response to these circumstances has played a crucial role in this experience.

As pointed out from the first diagnostics, the lasting deterioration of the terms of trade and its impact on national income demanded a coherent adjustment in the spending of the economy in harmony with the lessened dynamics of income in order to prevent the unsustainable growth of the current account deficit and external indebtedness.

Gross domestic product (GDP) and balance of payment figures in the first quarter of the year show that this certainly necessary adjustment is taking place. The annual growth rate of domestic demand was 1.3%, at a rhythm below the 4.7% expansion observed in the first quarter of 2015. For the same periods, the current account deficit shifted from 7.0% to 5.6% of GDP. As explained in the Report, both behaviors are mutually related.

As it could be expected, domestic demand slowdown as a result of national income deterioration and a raised interest rate has been reflected on a decline in the impetus of the economic activity. For the first quarter of 2016, an annual growth rate of 2.5% in GDP was recorded, lower than those observed in 2015 (3.1%) and the last quarter of the previous year (3.4%).

Consumption deceleration and investment slowdown have reduced imports (by – 24.5% in the first quarter), where the purchases of inputs and capital goods for industry and transportation equipment have to be highlighted. In this behavior, an important role was played likewise by the Colombian peso depreciation in making the cost of imports more expensive, thus discouraging demand. Regardless of the fact that the value of exports of goods was reduced in the first quarter at an annual rate of -29.7%, mainly as a result from lessened sales of oils and oil derivatives, the trade balance declined. In addition, the loss of firms operating in the oil activity was reflected on the annual drop of net expenditures driven by factor income. All of this has had an effect on the correction of the current account deficit. Given the larger reduction of expenditures in comparison with the contraction of current income, a current account deficit closer to 5.3% of GDP is projected in the most likely scenario for 2016.

GDP performance during the first three months of the year, according to its demand components, was mixed. While private consumption was recording a growth 3.4% higher than that of the fourth quarter of 2015 (2.8%), public consumption exhibited a slowdown (of 1.6% vs. 3.8%), explained in part by the adjustment to the fall of the oil price. On its side, gross capital formation registered an annual contraction of 3.7% mainly originating in the transportation, machinery, and equipment items.

In contrast, investment in construction achieved an 11.4% expansion thanks to the dynamics displayed in the construction of buildings. In the case of civil works, a growth rate of 0.4% was observed, due in part to a high comparison base in the same period of 2015. On the side of supply measuring the performance of the productive sectors composing GDP, the higher growth rates were seen in the industrial sector (5.3%), construction (5.2%), and financial services (3.8%). The only shrinkage was recorded in the working of mines and quarries (-4.6%).

In a context of a weakening demand and economic growth slowdown, it seems rather paradoxical that consumer price inflation has happened to exhibit the most significant upturn since the inflation-targeting scheme with exchange flotation was initiated. However, as it has already been explained in diverse *Banco de la República* reports and releases, the current inflationary pressure is mainly due to supply factors of transient origin, deriving for the accrued depreciation of the Colombian peso and the impacts of the El Niño phenomenon on agricultural and energy supply. These factors have unpinning inflation expectations and activated price and salary indexation mechanisms.

In this way, so far this year, an increase has been observed in consumer price inflation (CPI) from 6.77% on 2015 to annual 8.60% in June.

Annual variances in food pricing topped 14.28% in June. The prices of perishable items like potatoes, vegetables, fruits and dairy products was particularly

affected by a prolonged drought, and those of imported origin foods like cereals, oils and some processed products also came under pressure from the Colombian peso depreciation, even regardless of the fact that their international prices have remained stable since the beginning of year 2015. Given the influence of food prices in the family basket (28.2%), this is the item that has contributed most to inflation acceleration in the first half of the year.

The pass-through of nominal Colombian peso depreciation to domestic prices was another important source of upward pressures. As already explained in former Reports, the channels of the pass-through of the exchange rate on prices are of a diverse nature, among which the one operating through imported consumption stands out, as well as that making it via the producer price increase due to the higher costs of imported input and capital goods. In the group of tradable goods, the items concerning vehicles, household appliances, electronic and communication devices, and medicines, among others, are some of the most affected. Likewise, with the use of a cost channel, the pass-through is extended to non-tradable goods in the production of which imported inputs are used. In this occasion, the magnitude thereof has been high vis-à-vis the 2006 and 2008-2009 depreciation cases. In part, this can be explained because, unlike previous episodes, the exchange rate has not gone back to the levels prior to the terms-of-trade shock. Nevertheless, if a comparison is made with the experience observed in other countries, the pass-through effect is relatively low.

These pressures have affected core inflation measures. Thus, for the average of their four indicators monitored by *Banco de República*, their level in June was 6.52% in comparison with a record of 5.43% in December 2015.

The shocks described above have been more intense and longer than expected and anticipated by the Bank's technical staff and market analysts, to the point that inflation observed exceeds the forecasts carried out early in the year. Notwithstanding this, and as pointed out by the Board of Directors, the nature of any such shocks is of a temporary nature. To the extent that the *El Niño* phenomenon ended in the second half of the year and the rainfall levels have risen, farming and cattle raising supply must tend to go back to normal. In this manner, the increasing pace of food prices is expected to start declining around the third quarter, without ruling out some specific pressures due to the impacts that the recent difficulties may entail for the mobilization of food products from the countryside to the urban zones in the country.

In turn, the effects of Colombian peso depreciation on family basket prices should tend to decline in the course of the second half of 2016, because there is no sign of a marked upward trend in the exchange rate in the elapsed months of this year.

Since observed inflation makes part of the information set upon which people base their inflation expectations, price shocks, even those of a temporary na-

ture, may affect any such expectations. These effects depend upon credibility on the inflation target. If it is high, then the influence of transitory price shocks on medium and long-term prospects will be minimal. Otherwise, if it is low or if it weakens, temporary shocks gain importance because, in the shaping of their inflation expectations, more weight is given by agents to observed information. In other words, they tend to look backwards rather than forwards.

The most recent Colombian experience illustrates this conduct. In the face of the force and persistence of the above-described price shocks, expectations went up in September 2015 at the same time that price indexation mechanisms were activated.

In order to stop this process, an active monetary policy capable of helping preserve credibility in the target is required. For this purpose, the Board of Directors initiated in September 2015 a gradual increase of the policy interest rate from a 4.5% to a 7.75% level in July 2016. This increase in the interest rate at which *Banco de la República* supplies liquidity to the banking system means that a switch has taken place from a comfortable monetary policy to another that diminishes the stimulus to private spending. This reduces inflationary pressure and helps adjust increase in demand to the lower growth path of the national income.

The use of the interest rate as a vital instrument of monetary policy was supplemented with a communication strategy that, through multiple channels, has helped the Board and its technical staff to explain to the public the situation of the economy and the reasons serving to justify the successive interest rate increases. The monetary authority is aware of the fact that transparency is a fundamental ingredient in the construction of credibility.

Increases taking place in the policy interest rate have been reflecting on raises in the financial system's deposit and lending interest rates. The former increases remuneration of savings and the latter makes credit more expensive. As a result, economic agents are finding out that increasing their financial assets becomes more and more attractive while being more prudent in their indebtedness and spending is more advisable, all of this contributing to macroeconomic adjustment which is a necessary condition to achieve growth likely to be sustainable in production and employment.

The Report analyzes other important variables such as employment and financial system risk since both might be affected by the loss of dynamism in the economic activity and the interest rate increase. For those indicators, an accommodation to the new economic condition without great upheavals has been observed.

In the case of the labor market, figures available as of May did not show significant deterioration in the employment situation. Although the major thirteen

cities, and for the national total, certain slowdown has been recorded in the pace of new-job creation, this has coincided with a reduction in labor supply as shown by the lower overall participation rate. As a result, the unemployment rate in urban areas has shown some decline, and a marginal increase in the national total.

As for financial risk, the Report examines the exposure of credit establishments to credit and funding risks and analyzed the market risk in the Colombian Treasury Bonds portfolio. In this respect, the Report notes that the indicators for risk quality and default quality as of April 2016 recorded deteriorations as compared with what had been observed a year before, but their values remain at levels close to the average of the past five years. On the other hand, as of June, the liquidity indicator suggests that the financial system has the necessary liquid resources required to sufficiently meet its short-term contractual and non-contractual obligations. With respect to the risk measure for the system in the Colombian Treasury Bonds portfolio as of June, an increase was registered as a consequence of higher volatility in the public debt market.

Finally, and as pointed out in last year's July Report of the Board to the Colombian Congress, it is worth stressing the importance of progress made in the legislation regarding the regulation of conglomerates and capital consolidation in financial entities as a contribution to the financial system's resilience. Likewise, emphasis is made on a fiscal policy capable of ensuring the sustainability of the country's public finances and helping attain a balanced adjustment of public and private sectors to the permanent drop of income and the spending capacity of the economy, just as noted in the Report to the Congress of March of the current year. For this purpose, it is essential to continue with the austerity policy in spending and income increase ensuring compliance with the fiscal rule and the preservation of consumer and investor confidence. This is the only way to maintain favorable conditions of access to external financing helping the country continue the gradual adjustment in the economy that has been and is being met at the moment.