

# INTRODUCTION

During 2016, the Colombian economy advanced in the process of the macroeconomic adjustment required to restore the foundations for sustainable economic growth. The negative shock to the terms of trade, of great magnitude and permanent character due to the fall in the price of oil, caused imbalances that could have led to a severe economic crisis, with a significant loss of welfare. This danger has dissipated due to the fact that nowadays the Colombian economy has better institutional arrangements, such as flexibility of the exchange rate, which enable it to adapt to unexpected situations. The response of the economic policies, both monetary and fiscal, has played a key role by strengthening the automatic adjustment mechanisms that stabilize the economy.

The nominal depreciation of the peso, close to 60% compared to when the shock took place, caused a strong increase in the relative price of tradable to non-tradable goods, which led to an adjustment of the external imbalance, whose results can now be verified. Added to this, the decline in the terms of trade itself negatively affected national income, and hence domestic demand, which, by reducing total expenditure in the economy, contributed to the external adjustment. Thus, imports of goods fell by 15.6% and 7.0% in 2015 and 2016, respectively, a result not mediated by increases in tariffs or administrative restrictions, as it used to be.

Although a positive response of exports to the stimulus of the exchange rate would have been desirable, this has not taken place due to the weak global demand, and particularly to the fact that our most important trading partners (besides the United States) were also affected by the fall in the price of oil, thus preventing an expansion of trade. Despite this, the current account deficit, which reached USD 18,780 million in 2015 (6.4% of GDP), fell to USD 12,541 million (4.4% of GDP) in 2016. As detailed in the section on the balance of payments, a better balance of net factor revenues also contributed to this adjustment, due to the lower remission of profits abroad by enterprises with foreign direct investment, mostly due to the effect of the shock on the terms of trade.

The important role played by the flexibility of the exchange rate in the adjustment process is beyond any doubt. This did not happen during the external shock of the late 1990s, which plunged the country into a serious economic crisis. However, the depreciation of the peso brought about a collateral effect:

the inflationary pressure caused by the higher costs of final goods and imported raw materials. This effect was even more noticeable because the country was coming from a period of appreciation of its currency, which made imports cheaper and increased its insertion in the production chain. Consequently, the annual inflation of tradable goods (excluding food and regulated items), which had been negative until mid 2011 and which did not exceed 2.0% before the shock, suffered a sharp increase, reaching 8.0% by mid 2016.

The effect of *El Niño* phenomena added to the pass-through of depreciation to prices, already significant by itself. The intense and prolonged drought caused by *El Niño* throughout the Colombian territory reduced the food supply, thus increasing food prices. Hence, annual food inflation, which stood at around 3.0% by mid 2014, increased almost uninterruptedly, reaching 15.7% annually in July of 2016.

The simultaneous increase in the inflation of tradable goods and food put indirect pressure on non-tradable goods inflation due to the higher cost of their inputs and to the activation of some indexation mechanisms. As a result, non-tradable goods inflation began to show successive increases from a 3.25% annual level by mid 2014 to over 5.0% in February 2017.

This inflationary pressure came not from excess demand, as it was slowing down due to the slower growth pace of national income following the deterioration of the terms of trade. The monetary authority faced one of the most complex dilemmas for any central bank: hiking inflation caused by exogenous supply shocks that hindered reaching the target and affected credibility, and a declining economic activity that drove the economy away from its potential capacity and undermined the confidence of both consumers and businesses.

After assessing the forecasts for inflation and economic activity and the behavior of economic agents' expectations, the Board of Directors of *Banco de la República* (BDBR) decided to begin a hike cycle of the benchmark interest rate from 4.5% in September 2015 to 7.75% in July 2016. The challenge of the policy was to balance the risks of a too-slow convergence of inflation to the target, on the one hand, and an excessive deceleration of economic activity, on the other. A faster convergence of inflation would have required a very strong deceleration of the economy, bringing about a significant cost in terms of employment. On the other hand, a slower convergence would have entailed the risk of perpetuating inflation expectations above the 3.0% target and extending the indexation mechanisms, thus raising the cost of a future disinflation. Considering this, the Board decided it would be desirable to seek a gradual convergence of inflation to the target.

In this context, consumer price inflation by the end of 2015 was 6.77%, and during the first half of 2016 it continued to increase, reaching a peak of 8.97% in July when the trucking strike was added to the already existing pressures. This trend had a significant break starting August thanks to the fact that the

effects of the shocks herein described began to fade, and that the policy actions taken since 2015 contributed to moderate inflation and inflation expectations. Thus, inflation closed at 5.75% in 2016, and during the first months of 2017 it continued to recede, reaching 5.18% in February. This downward trend of price variation was predictable, given the transitory nature of *El Niño* and the pass-through of depreciation to prices. The Board reiterated this to the public opinion in all of its communications, with the purpose of preventing an unjustified increase in inflation expectations.

The fall in the terms of trade weakened the National Government's finances, given that oil revenues accounted for about 20% of its total income. To offset this shock, the government reduced spending and introduced a tax reform to Congress in order to raise the value-added tax (VAT) and other indirect taxes starting 2017. Such increases push the prices of various articles of household consumption up, causing the convergence of inflation to its target to be slower, which in turn induces economic agents to revise their inflation expectations upwards. On top of this is the additional pressure that arises from the recent increase in the minimum wage above the inflation rate observed in 2016.

This policy dilemma requires the monetary authority to review the risk balance between inflation and growth more regularly and rigorously. As part of this process, in its sessions of December 2016 and February and March of this year, the Board of Directors decided to lower the benchmark interest rate by 25 basis points (bp) on each occasion, reaching a level of 7.0%. As reported opportunely, such decisions have taken into account the continuity of the decline in the indicator for headline inflation and its outlook, the weak performance of the economy, and the favorable reduction in the current account deficit, among other factors. Yet, the monetary policy stance continues to be contractionary, which is consistent with the purpose of seeking a gradual convergence of inflation to its target.

GDP growth in 2016, at a rate of only 2.0% as reported by the National Administrative Department of Statistics (DANE), confirms the severity of the shock to the terms of trade, which, having contributed negatively to national income, weakened the dynamics of consumption and investment, and affected the performance of many branches of activity. Additionally, other shocks such as *El Niño* and the trucking strike deepened the slowdown.

On the demand side, the most affected component was that of gross capital formation, which recorded a 4.5% contraction in the year. This result is due greatly to the reduction of investment in machinery and equipment as well as in transport equipment as a reflection of the decline in the mining sector and the depreciation of the peso. This was partially offset by the good results in construction of buildings and civil works, driven by the government's housing construction programs and road-building projects. Total consumption also contributed to the slowdown, registering a 2.0% growth, lower than had been observed in 2015. In this case, the most affected items were household consumption of durables

and semi-durables. Thus, domestic demand remained virtually stagnant, with a growth figure of just 0.3%. In a context of low demand, the different branches of activity exhibited low or negative growth, except for financial services, construction, and industry, the former driven by the reopening of Reficar.

Despite the slowdown in economic activity, resilience of the labor market should be highlighted. For the average of the fourth quarter of the year, the unemployment rate in the main thirteen metropolitan areas was 9.2%, *vis-à-vis* 8.9% in the same period of 2015. Something similar happened to the national total, whose average for the last quarter of 2016 amounted to 8.2%, compared with 8.0% a year before. The stability of the unemployment rate is surprising, considering that the economic activity stepped down from a 4.4% growth in 2014, to 3.1% in 2015 and 2.0% in 2016. As discussed in the document, the reason for this is that, while labor demand shrank (occupation rate: OR) due to the effect of lower growth, so did the labor supply (global participation rate: GPR). The latter is an atypical behavior compared to past periods of slowdown, given that the GPR is usually a counter-cyclical variable that increases when the economy falls, and vice-versa. The technical staff is currently investigating the phenomenon with the purpose of providing an explanation in the next report.

It should be noted that a factor that allowed for a gradual adjustment of the external sector and the economy in general facing the oil shock was the external funding that the rest of activities continued to receive. This behavior reflects the continued confidence of foreign investors in the Colombian economy and their ability to overcome the shock. Larger purchases of public debt bonds by foreigners stand out, as well as the increasing acquisition of loans and other external credits by the Government and other public entities. In addition to this, the sale of Isagen also contributed to the country's incoming resources. All this allowed to partially offset the lower amount of foreign capital received by the mining and oil sectors, specifically those related to direct investment.

Preserving the confidence of external markets in the midst of such a strong shock as that which struck the Colombian economy cannot be taken for granted. Largely, this depends on the country's economic institutionality. The flexibility of the exchange rate and the independent management of the monetary policy under the inflation-targeting regime contributed to this. Similarly, the existence of the fiscal rule and strict compliance with it has played a key role in maintaining trust. In this context, in order to ensure compliance with the goals of the fiscal rule and ensure the sustainability of public debt in the medium term, the Government introduced a tax reform that was approved by the Congress at the end of 2016. With the reform, the Government expects to gradually increase collection from 0.7% of GDP in 2017 to 3.1% of GDP in 2022. With this additional income and the adjustment in operating and investment costs, the Government expects to resume the downward path of the fiscal deficit, which is estimated at 3.3% of GDP for 2017, compared with 4.0% in 2016.

The perception of a solid institutional context and an appropriate policy response, together with the reduction in the current account deficit, the downward trend of inflation, and the approval of the tax reform, has reduced uncertainty and increased the confidence of the markets.

This Report examines the outlook for the main macroeconomic variables for 2017. On the external front, it highlights the expected improvement in global economic conditions, thanks to the strengthening of growth in developed economies. Regarding the international price of oil, although there is uncertainty about its dynamics, it should continue to respond to the expected supply reduction.

As for the Colombian economy, its performance will be framed in the continuation of the adjustment process to be completed this year. With this, the technical staff forecasts GDP growth for 2017 between 0.7% and 2.7%, with 2.0% as the most likely figure. The amplitude and downward bias towards the lower part of the forecast range suggest the possibility of a slow dynamism of economic activity. Regarding inflation, the lagged effects of *El Niño* and the accumulated depreciation of the peso are eventually expected to disappear. This, along with modest growth of demand and the effect of the monetary policy actions taken since 2015, should limit price adjustments and reduce inflation expectations, which will favor the convergence of inflation to its 3.0% target. Finally, the correction of the external imbalance that began in 2016 is expected to continue in 2017, with which the current account deficit would be expected to stand between 3.0% and 4.4% as a percentage of GDP, with 3.7% as the most likely figure. The additional adjustment to the current account estimated for 2017 would be explained not by a reduction of expenditures resulting from lower imports, but by the increase in revenues, mainly due to larger exports of goods.