Developments in inflation and monetary policy decisions

The momentum in global economic activity during the first half of 2015 was weaker than expected. Growth in the United States economy eased during that period and recovery in the euro zone and Japan was sluggish. China´s economy slowed somewhat more than anticipated, while the larger Latin American economies posted low or negative growth rates, below the estimates. These results led to weaker foreign demand for Colombian products than was estimated earlier.

The US dollar continues to gain strength and the Federal Reserve is expected to raise interest rates in the United States sometime between now and the end of the year. The international price of oil fell, as did prices for other commodities exported by Colombia, causing a drop in terms of trade. The negative effect this had on national income played a role in increasing the country's risk measurements. All this partly explains the sharp devaluation of the peso against the dollar, which will help to cushion some of the negative impact on growth caused by lower terms of trade.

Under these conditions, domestic spending in Colombia is adjusting to the decline in national income. As for the second quarter of 2015, the indicators of retail, consumer and business confidence, economic expectations, imports of capital and consumption goods show domestic demand slowed. In view of the foregoing and with the trend observed in foreign demand for domestic goods and services, Banco de la República's technical staff estimates that economic growth in the second quarter of 2015 would have been similar to the figure on record for the first quarter. The most likely forecast for GDP growth in all of 2015 was revised downward from 3.2% to 2.8%, within a range of 1.8% to 3.4%. This revision, in terms of the April forecast, was due mainly to expectations of lower growth for our trading partners, less government consumption and building construction.

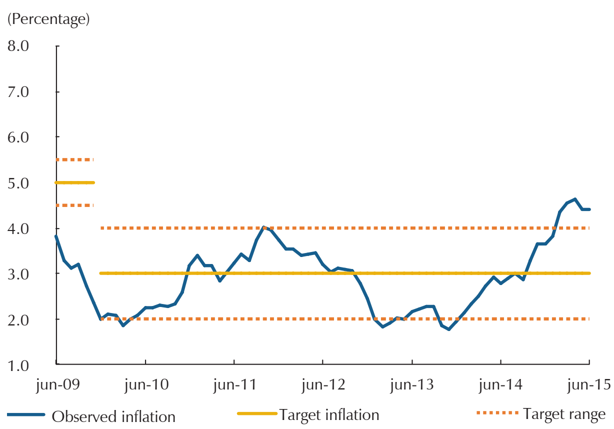
In June, annual consumer inflation (4.42%) remained relatively stable and the average of the four measures of core inflation (4.14%) increased for the ninth month in a row (Graph A). The build-up in inflation witnessed so far this year is explained largely by a reduced food supply, pass-through of nominal depreciation to consumer prices, and higher costs for imported raw materials.

The forecasts developed by the technical staff at Banco de la República suggest inflation by the end of 2015 will be near the current levels and should begin to converge towards the target (3%) in 2016. So far, the available indicators of inflation expectations show market agents also perceive the increase in consumer prices as a temporary phenomenon. This is evident in analysts' inflation expectations one and two years forward, and in those derived from TES at two, three and five years, which are still at around 3%.

However, there is a risk that necessary movement in a relative price such as the exchange rate, combined with other supply shocks, might unanchor inflation expectations at horizons of more than one year. There is also the risk that the extent of the adjustment in spending might not be consistent with macroeconomic stability. According to the economic situation described above, inflation is likely to stay above the top of the target range during the remainder of the year and domestic spending in the economy will continue to adjust gradually to the slowdown in national income. The temporary prices shocks are expected to reverse sometime within the horizon for monetary policy action, in an environment of inflation expectations that are anchored to the target. Under these conditions, the Board of Directors considered it appropriate to hold the interest rate at 4.5% (Graph B).

The Board of Directors will continue to monitor inflation and inflation expectations, the extent of the adjustment in domestic spending and its coherence with macroeconomic stability. It also reiterated its commitment to keeping inflation and inflation expectations anchored to the target, while acknowledging the temporary build-up in the pace of price hikes.

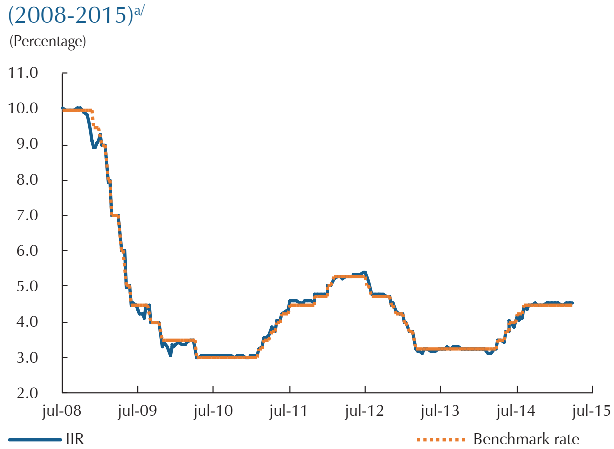
Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República

Graph B

Banco de la Republica's Benchmark Interest Rate and the Interbank Interest Rate (IIR)
(2008-2015)[a/]



A/ The figures pertain to data on business days; the last figure is for July 31, 2015.
Sources: Superintendencia Financiera de Colombia and Banco de la República

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