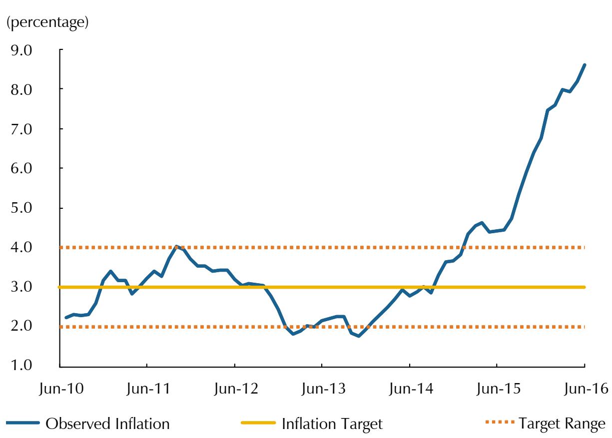
Inflation Developments and Monetary Policy Decisions

During the second quarter of 2016, annual consumer inflation and the average of core inflation indicators continued to rise, reaching 8.6% and 6.5% by June, respectively (Graph A). Meanwhile, inflation expectations in July were still above target; in fact, analysts predict 4.6% and 3.7% for one and two years ahead. Inflation expectations resulting from the quarterly survey applied to different economic sectors, within a two-year horizon, stood at 5.4%, while expectations derived from government debt bonds to two, three and five years are between 4.0% and 4.5%.

This behavior of consumer prices occurred in a context where economic activity continued to be affected by the decline in terms of trade and the subsequent deterioration in national revenue. A number of indicators suggest that output growth for the second quarter of 2016 would be similar to that of the first quarter. Consumption growth would be slower, while the drop in investment could be less. For all of 2016, the technical staff reduced its forecast for most likely growth from 2.5% to 2.3%, within a range of 1.5% to 3.0%.

Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República

The reduction in observed and expected domestic demand growth is compatible with the economy's adjustment to the shock to the terms of trade. However, despite the observed and expected slowdown in economic activity, Colombia still has a large external deficit. Moreover, in the wake of the oil shock, potential output growth is estimated to be declining as a result of the drop in gross capital formation, mainly in the oil and mining sector. In this context, the Colombian economy operated close to its productive capacity in 2014 and 2015, and some underutilization of that capacity began to emerge only as of 2016.

The international situation is still marked by the slowdown in external demand and low international interest rates. Global economic activity remained weak during the second quarter of this year, and the average rate of growth for Colombia's trading partners in all of 2016 is expected to be low and below what it was last year. Measurements of country risk continue to exceed the average observed in 2015, and monetary policy in the United States is likely to tighten slowly. If these trends continue during the rest of the year, the cost of external financing would remain low.

The country's terms of trade and the momentum in national revenue seem to have recovered in April and June compared to the decline witnessed during the first quarter of the year. This was due to an average international price for oil (USD 47 per barrel for Brent crude), which exceeded the low level registered in the first quarter (USD 35), but was still much less than the average price witnessed two years earlier (USD 110). Another contributing factor is the price drop in US dollars of a number of commodities imported by Colombia.

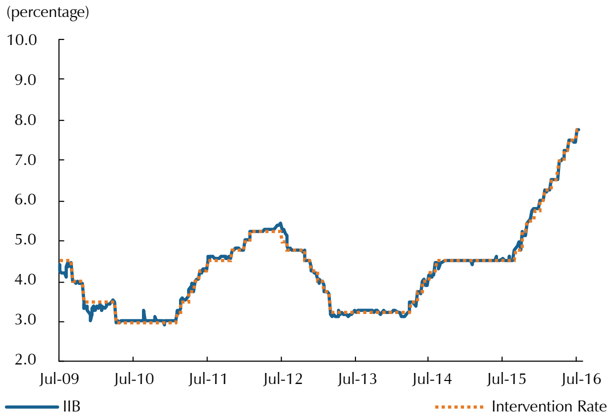
The performance of foreign trade can be explained largely by low oil prices, a higher exchange rate and weak external demand. The value of exports in US dollars fell 20% in the second quarter, mainly because of the drop in oil and mining exports (30% annually). Imports were down 18% during the two months between April and May. In terms of value, new data indicate that the trade imbalance continued to decline.

The observed and expected reduction in the external imbalance shows the economy's progressive and orderly adjustment to the lingering effects of the external shock. The technical staff anticipates a current account deficit relative to GDP of 5.3% for 2016 and 4.3% for 2017. This correction would reduce the country's external vulnerability, but the deficit would continue to exceed the levels observed in other economies with a risk rating similar to Colombia's.

For the second semester of this year, the technical staff expects that the normalization of food production, the stabilization of the exchange rate, and the effect of higher interest rates on domestic demand will all lead to a decline in inflation. The return of favorable weather conditions should prompt a reduction in food prices, primarily for certain perishables that were seriously affected by the prolonged drought. If the exchange rate does not trend sharply upward, there should be no additional external pressure on prices. Moreover, the negative output gap estimated for 2016 reduces the risk of demand-side inflationary pressures. In this setting, the technical staff's forecasts, which take into account an active monetary policy, suggest that inflation would be within a range of 6.5% to 7.0% by December, and would converge towards the target range of 2.0% to 4.0% by late 2017 with a probability of 42.0%. This probability is less than was estimated in the December 2015 and March 2016 editions of this report (77.0% and 51.0%, respectively), given the sharp and prolonged inflationary pressure observed to date.

In summary, the current situation is characterized by an increasing core and aggregate inflation above the target, long-term inflation expectations over

Graph B
Banco de la República's Intervention Rate and the Overnight Rate (OR)
(2009-2016)[a/]



a/ The figures pertain to working days. The last figure is for August 12, 2016.
Sources: Financial Superintendence of Colombia and Banco de la República.

3.0%, economic slowdown, and by a partial reduction of the external deficit. Annual CPI variation is expected to begin to decline during the second half of this year. The convergence of inflation towards the target during the projected horizon depends on there being enough of an adjustment in food prices, an absence of severe external shocks that might raise the exchange rate, and no expansion in the use of mechanisms for indexing prices and wages. Starting from low levels in mid-2015, the phase of policy interest rate hikes has led to real market interest rates which are now close to or narrowly exceed their historical averages. Despite the lower growth, the Colombian economy continues to operate near its productive capacity, the external deficit remains large, and the unemployment rate is at historically low levels. Given these circumstances, the Board of Directors analyzed the balance of risks and decided it was appropriate to raise the benchmark interest rate by 25 basis points at each of its meetings in May, June and July (Chart B).

José Darío Uribe
Governor