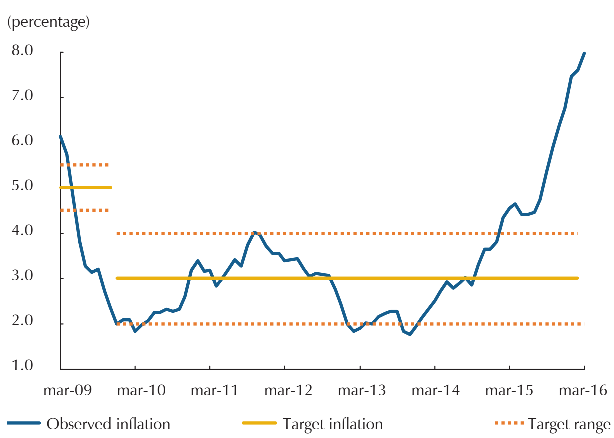
Developments in inflation and decisions on monetary policy

In March, annual consumer inflation was 7.98% and the four measures of core inflation averaged 6.29% (Graph A). The rise in inflation during the first quarter, which was higher than expected, can be attributed to the sharp hike in food prices, the partial pass-through of nominal depreciation to consumer prices and raw material costs, and the activation of indexation mechanisms for certain items in the family basket of goods and services, such as education, health care and some public utilities. Analysts expect inflation at one and two years to reach 4.5% and 3.8% respectively, while inflation expectations estimated from government debt bonds at two, three and five years are between 4.4% and 4.8%.

Although so far in this century the pass-through of peso depreciation to consumer prices has been limited, the exchange rate is high and could continue to have a lagged impact on prices for imported goods and services. Likewise, lower food supplies are expected up until the second quarter of 2016, when the weather is expected to return to normal. In this context, although both shocks are temporary, they still can exert upward pressures on inflation and its expectations, and continue to activate undesirable indexation mechanisms.

Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República.

With respect to worldwide economic activity, several of Colombia's trading partners, mainly the commodity-producing economies, have experienced weaker than expected growth. As such, the momentum in foreign demand for our export products is likely to be weak in 2016 and lower than its 2015 level.

In the United States, it is now more likely that the tightening in monetary policy will occur more slowly. The US dollar has depreciated in an environment of improving global liquidity conditions, increases in oil prices and some reductions of risk premia for the emerging market economies. There is a great deal of uncertainty on the future behavior of oil prices. In this context, although the deterioration in the terms of trade and national revenue has subdued somewhat, it is uncertain how long these improvements will continue in the remainder of the year.

Colombia's foreign trade and its financial account reflect the effects of a weak external demand, lower oil prices, and a higher exchange rate. Exports in dollars declined 32.0% y/y during the first quarter of 2016, mainly due to the drop in foreign sales of mining and energy products (-54.0% y/y). The value of imports fell 26.0% y/y during the first two months of the year. The current account deficit is expected to decline to about USD 16 billion during 2016, given the projected drop in imports of goods and services and the estimated reduction in profits remitted by foreign companies.

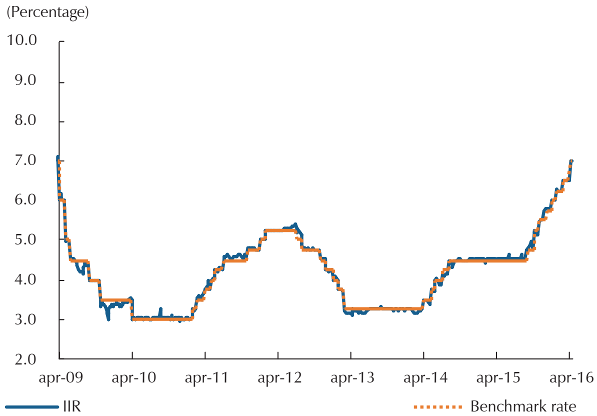
Domestically speaking, the figures for the first quarter of 2016 indicate household consumption would have grown at a pace similar to that on record at the end of 2015, while investment would have slowed. The real drop in imports would have exceeded the decline in export volumes. On the supply side, the indicators for industry, retail sales and coffee production suggest favorable performance, while those for mining signal deterioration.

Given all these factors, the technical staff at Banco de la República anticipates economic growth will likely amount to 2.5% in the first quarter of 2016, within a range of 2.8% to 3.2%. The forecast range of 1.8% to 3.2% for all of 2016 was maintained, and the most probable figure was reduced from 2.7% to 2.5%. As for inflation, the projections developed by the technical staff, which takes into account an active monetary policy, suggest inflation will decline in the second half of the year and end 2016 at around 6.0%, before converging towards the target range in 2017.

In short, the new data indicate the Colombian economy continues to adjust in an orderly manner to the strong shocks registered since mid-2014. The risk of an excessive slowdown in domestic demand remains moderate, while expenditure continues to exceed the national income, which is reflected in a high current account deficit. Inflation and inflation expectations have been affected and have been pushed to high levels by peso depreciation, more intense El Niño weather and the activation of certain indexation mechanisms.

In this environment, the response from monetary policy must consider that these price shocks are transitory. It also must be oriented to ensure that inflation converges to the target range of 3.0% ± 1 percentage point in 2017. As a result, the Board of Directors has taken steps to prevent the reaction of inflation and inflation expectations from being more pronounced and prolonged than the size and duration of these shocks. Therefore, the Board felt it was appropriate to raise the reference interest rate by 25 basis points in each of the first three months of the year and by 50 basis points in April.

Graph B
Banco de la República's Benchmark Interest Rate and the Interbank Interest Rate (IIR)
(2009-2016) [a/]



a/ The graph pertain to data for business days; the last figure is for 13 May 2016.
Sources: Financial Superintendence of Colombia and Banco de la República.

The increase in the reference rate and its effect on growth in domestic demand, coupled with real devaluation of the peso, also contribute to an orderly correction of the country's external imbalance (Graph B).

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