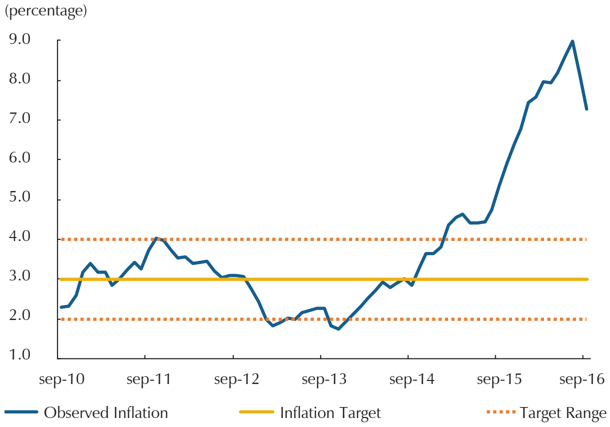
Inflation Developments and Monetary Policy Decisions

Annual consumer price inflation dropped for the second consecutive month, from 8.97% in July to 7.27% in September 2016. The slowdown, which was greater than expected, is mostly due to a lower increase in food prices, and –to a lesser extent– to the moderation in price increases for the goods and services that were most affected by past nominal peso depreciation. This suggests that the effects of the strong temporary supply shocks that diverted inflation from its target (El Niño weather and nominal depreciation) are beginning to fade faster than anticipated (Graph A).

The average of core inflation measures also declined, although not as much, moving from 6.61% in July to 6.29% in September. Inflation expectations subsided during the same period, although they still exceed the target for 2017. Analysts' inflation forecasts for one and two years are at 4.23% and 3.65%, respectively, while expectations derived from government debt bonds to two, three, and five years are around 3.6%.

Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República.

The economic indicators for the third quarter of 2016 suggest GDP growth was lower than during the first half of the year, with a weaker momentum in external and domestic demand than forecast three months ago. The average growth rate for Colombia's trading partners has been lower than expected, which is why the country's non-commodity exports performed poorly. Consistent with the decline in national income, domestic demand has continued to adjust. Additionally, the negative supply shock sparked by the truckers' strike seriously affected several sectors of the economy. In light of this data and with new figures on economic activity for the fourth quarter, the technical staff reduced its growth forecast for 2016 from 2.3% to 2.0%, with a new projected range between 1.5% and 2.5%.

This macroeconomic situation points to a slightly faster-than-anticipated adjustment in excess expenditure over income, which suggests a more pronounced correction of the external deficit than the one projected a quarter ago. Accordingly, the Central Bank's technical staff lowered its forecast for the current account deficit as a proportion of GDP from 5.3% to 4.7% (equivalent to US $13.2 billion). The slowdown in output and the reduced external deficit reflect the required adjustment by the Colombian economy in response to the negative shock to national income that the country has been facing since mid-2014.

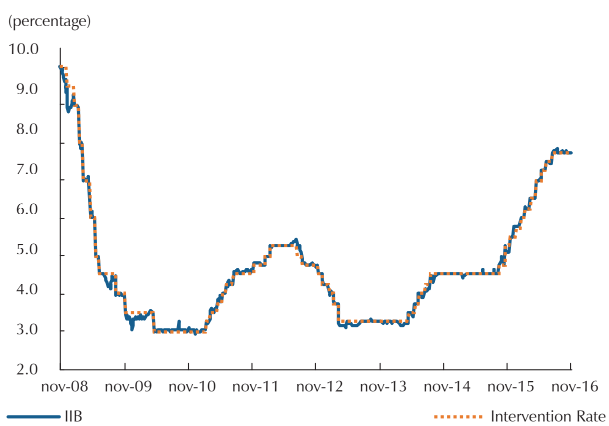
Considering price behavior and inflation expectations, the Bank's technical staff estimates that inflation will continue to converge towards its target in the coming months. The slowdown in food prices should persist at least until the first quarter of next year, given a greater supply in this group, particularly regarding perishables. In the absence of new shocks, the pass-through on inflation of the significant peso devaluation is expected to continue fading. A weakening in demand would contribute more to the reduction in inflation than in previous months. Additionally, as long as inflation expectations tend to anchor at 3.0%, price-indexing mechanisms will be more compatible with the target.

In summary, the Colombian economy continues to adjust to the strong shocks experienced since 2014, and the current account deficit is declining gradually. The dynamism in output has been weaker than anticipated, and although inflation has declined, inflation expectations for 2017 still exceed the target. The consequences of the supply shocks that affected price levels and inflation expectations have begun to reverse, and this trend is expected to persist.

With the current figures, the risk of the economic slowdown being more pronounced than the decline in national revenue and the risk of inflation converging more slowly towards the target for 2017 appear to be subdued. In light of this assessment, the Board of Directors decided to keep unaltered the level of policy interest rate during its August, September, and October meetings. New information on price behavior and aggregate demand will provide further indications about the speed at which inflation is expected to converge towards the target, and about the intensity, nature, and persistence of the economic slowdown (Graph B).

In light of the negative effects that the fall in oil prices has had on public finances, the Board also felt the Tax Reform Bill presented by the

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 November 15, 2016.
Sources: Financial Superintendence of Colombia and Banco de la República.

Government to the Congress is a fundamental action that contributes to long-term growth by strengthening fiscal sustainability, fostering macroeconomic stability, and reducing the country risk perception.

José Darío Uribe
Governor