Developments in Inflation and Monetary Policy Decisions

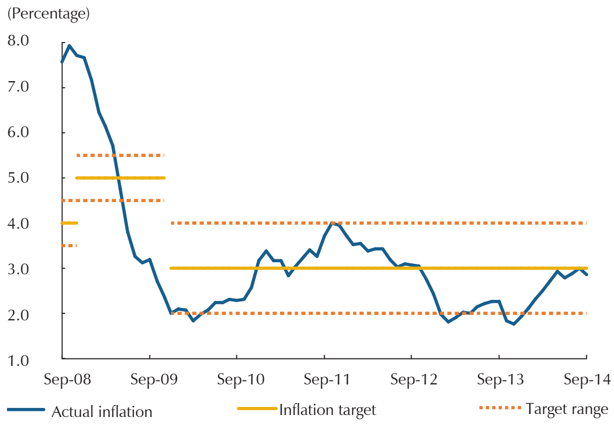
The Colombian economy performed well between June 2013 and the same month in 2014, in contrast to the low growth reported by the largest economies in the region and other emerging countries. Colombia's output rose 5.5% during this period, up from 3.2% in the previous four quarters.

There are several reasons why the Colombian economy outperformed others in the region. The first is the monetary policy stimulus that came from lowering the benchmark interest rate from 5.25% to 3.25% between July 2012 and March 2013. This was done in an environment where inflation and inflation expectations remained at low levels and there was an excess of spare capacity in the economy. The low real interest rates, together with high levels of confidence, bolstered consumption and private investment. Secondly, the strong increase in civil works and building construction during the first half of 2014, as well as more public spending, fueled domestic demand in a context of weak external demand.

The last reason is that international oil prices fell, but not at the pace of the decline witnessed in some commodities exported by other emerging economies, and coffee prices remained high. So, the deterioration in Colombia's terms of trade up to the first half of the year was less than in the case of other commodity-exporting countries. Moreover, external portfolio flows increased significantly as of the second quarter of 2014, after JP Morgan rebalanced its index in sovereign emerging markets bonds. This higher rate of external financing, accentuated in the third quarter, helped to maintain the momentum in domestic demand.

With respect to prices, inflation began to converge towards the long term goal (3%) as of early 2014, from the low level registered in late 2013 (Graph A). The various measures of core inflation and inflationary expectations behaved similarly. At the same time, the economy continued to show signs of strengthening and approached its long-term potential output.

Graph A
Total Consumer Inflation



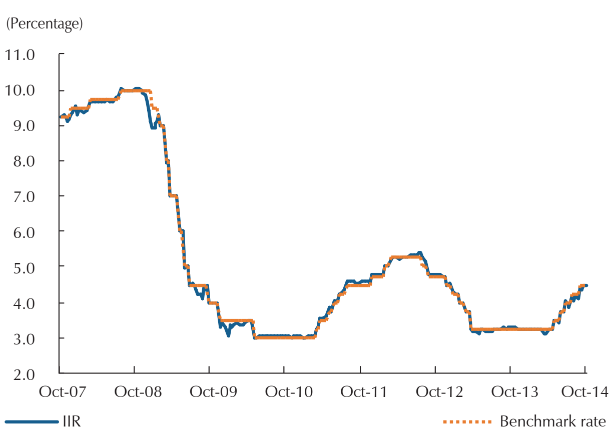
Source: DANE and *Banco de la República*

Given these circumstances, the Board considered appropriate to move towards a less expansionary monetary policy stance. Accordingly, between April and August 2014, it gradually raised the benchmark interest rate, by 125 basis points, to 4.5% (Graph B).

Annual inflation was 2.8% by the end of the third quarter, just as the technical staff had anticipated. The four measures of core inflation declined and averaged 2.63% in September. Analysts' average inflation expectations at one year and those derived from public bonds with longer maturities remain stable, at slightly above 3%. The estimates also suggest that the year-end inflation may be in the upper half of the target range.

As for the external situation, the indicators of global activity towards the end of the third quarter of 2014 suggest external demand was weaker than expected. So, the new average growth forecasts for our trading partners during the remainder of 2014 and in 2015 declined. According to those predictions, foreign demand would be driven primarily by the United States, while the euro zone would be sluggish. China would experience a slight slowdown, and some trading-partner countries in the region would continue to grow at rates below their averages in recent years.

Graph B
Banco de la Republica's Benchmark Interest Rate and the Interbank Interest Rate (IIR)
(2007-2014) [a/]



a/ The figures pertain to data for business days; the last figure is for October 10, 2014.
Source: Colombian Superintendence of Finance and Banco de la República

Domestically, the new indicators of economic activity in the third quarter of 2014 suggest a slightly less GDP growth compared to the first half of 2014. The performance of retail sales, consumer credit, the consumer confidence index and the labor market all suggest the strong momentum in consumption would continue. The increase in foreign purchases of machinery and transportation equipment, and the trend in civil works suggest investment will perform well, though at rates below those observed in the first half of the year. The foreign trade indicators suggest net exports would have contributed negatively to growth.

The annual increase in bank loans continued to decline during the third quarter, but is still growing at higher annual rates than the nominal GDP estimated for this year. The reduced momentum was in commercial loans. The slowdown in mortgage lending during the same period was offset by a slight increase in consumer loans; consequently, growth in lending to households did not change. All this occurred in a context marked by weak pass-through of the benchmark interest rate hikes to interest rates on loans.

With the new information on external and domestic economic activity, the technical staff forecasts a level between 4.5% and 5.5% for the economic growth in 2014; with 5% as the most likely figure. The risks towards 2015 are originated mainly in the external sector. Specifically, there is uncertainty about how oil prices will behave their direct and indirect impact on the Colombian economy, and how the European economy will perform. The normalization of monetary policy in the United States raises concerns in the markets.

However, the recovery of the United States will be a positive factor, since that country is our largest trading partner. In turn, the exchange rate is beginning to play an important stabilizing role against negative shocks from abroad. Finally, the credibility of the inflation target gives monetary policy some maneuvering space. In general, the task of economic policy will be to maintain confidence in the Colombian economy, amidst an uncertain scenario.

In short, growth in domestic demand remains strong in a context of nearly full utilization of productive capacity. At the same time, inflation expectations are still close to 3%. This is in an environment of declining terms of trade and growing uncertainty about the recovery in global economic activity and the cost of external financing. These factors could influence aggregate demand and the exchange rate.

Having assessed the risk balance, the Board of Directors decided - at its meetings in September and October 2014 - to make no change in the benchmark rate. This decision was taken in an environment of declining terms of trade and growing uncertainty about the recovery in global economic activity and the cost of external financing. These last factors can affect aggregate demand and the exchange rate.

José Darío Uribe
Governor