Monetary Policy Report

A regular meeting of the Board of Directors of Banco de la República took place in the city of Bogotá D.C. on Friday, March 18, 2016. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; José Darío Uribe Escobar, Governor of the Central Bank; and co-directors Carlos Gustavo Cano Sanz, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, Cesar Vallejo Mejia, and Juan Pablo Zárate Perdomo.

These minutes contain a summary of the outlook of the technical staff of the Central Bank on the macroeconomic situation (section 1), followed by a review of the main discussion regarding monetary policy by the Board of Directors (section 2).

Further detail on the macroeconomic situation prepared by the technical staff from Banco de la República will be presented in the Monetary Policy Report of February and in the statistical annex.

# 1. MACROECONOMIC CONTEXT

1. In recent weeks, the international prices of oil and other commodities increased. Also, the US dollar weakened and volatility at international financial markets reduced. Among other factors, this is due to a greater provision of liquidity in advanced economies, to a prospect of a more gradual increase of the benchmark interest rate by the Fed than expected, and to the stimulus policies announced in China.

2. Consistent with this and in line with other emerging economies, the value of the Colombian peso vis-à-vis the US dollar and the country's risk premia reversed part of the deterioration observed at the beginning of the year. However, the levels of both indicators continue above the averages registered in 2015.

3. The records for global economic activity in January and February suggest that growth of Colombia's main trading partners for 2016 would still be weak and would be similar to that observed in 2015. This is due especially to the poor performance expected for Latin American economies with which the country has important trade relations.

4. The US economy would continue to be driven by private consumption, the euro area would maintain a slow recovery, and China would keep slowing down. In Latin America, the figures for the fourth quarter confirmed the deepening of the recession in Brazil and a modest expansion in Mexico and Peru. In Chile, the indicator of activity suggests that the expansion remains low. Growth figures have not been yet published for Venezuela and Ecuador, but leading indicators suggest contractions in their GDP.

5. In January, the value of the country´s foreign sales in US dollars fell 36.2% on a yearly basis, exhibiting significant reductions for the different groups. At the same time, the value of imports fell 28.0%.

6. According to the latest figures published by DANE, GDP grew 3.3% during the fourth quarter and 3.1% for all of 2015. On the side of expenditure, domestic demand slowed compared to 2014 (from 6.0% to 3.6%). However, the figures for consumption and investment in the last quarter were more dynamic than had been expected. Acceleration of the tradable sectors took place in the second semester (from 0.9% in the first semester to 2.0% in the second), as well as a slight deceleration of non-tradable goods (from 4.2% to 4.0%).

7. The few figures available for 2016 show mixed signals. On the one hand, with information to January, retail sales (excluding vehicles), cement production and dispatch, and industrial production exhibited growth, which in several cases surpassed those expected by the technical staff from the Central Bank and by economic analysts. Similarly, to February, coffee production also experienced a favorable increase, in spite of the high basis for comparison.

8. On the other hand, the unemployment rate showed a significant increase in January, confirming the increasing trend that began at the end of 2015. With information to February, oil production lowered, household indebtedness continued to slow down, and the consumer confidence index remained at its lowest since April 2002. Additionally, the Government cut spending for the present year.

9. With all of the above, the technical staff maintained its forecast range for GDP growth for 2016 between 1.5% and 3.2%, with 3.0% as the most likely figure.

10. The figure for yearly consumer inflation in February posted at 7.59%, the highest since December 2008. However, monthly variation (1.28%) was lower than expected by the Central Bank and by the market. The average of core inflation indicators monitored by Banco de la República stood at 6.07%.

11. Unlike the previous months, when upward pressures on inflation originated in food and tradables, the increase of inflation in February was explained by the behavior of regulated items and non-tradables excluding food and regulated items. In addition to the effects of El Niño and the depreciation of the peso on these groups,

prices increases could be associated with the activation of indexation mechanisms and increased labor costs. The variation in the prices of tradable goods (excluding food and regulated items) and food remained high, but it was lower than the one observed in January.

12. Inflation expectations collected from the monthly survey to economic analysts in March stood at 5.72% for December this year, 4.41% to 12 months, and 3.77% to 24 months. Those embedded in public debt bonds to 2, 3, 5, and 10 years decreased so far in March vis-à-vis the previous month, although they remain above 4.4%.

13. The effects of El Niño, pass-through of the depreciation of the peso to prices, and the activation of indexation mechanisms on prices and salaries could keep inflation high during the first semester of the year. Shocks in food prices and depreciation are expected to begin fading in the second semester, which, together with actions in monetary policy should lead inflation towards its target during 2017.

In summary, a significant gap between expenditure and national income persists. High increases in food prices and the partial pass-through of depreciation to domestic prices continue to exert inflationary pressures. Inflation expectations remain high, and the risk of a slowdown of domestic demand in excess of that which is consistent with the decline in national income continues to be moderated.

# 2. DISCUSSION AND POLICY OPTIONS

The members of the Board agree that it is necessary to continue increasing the benchmark interest rate. Although the increase in inflation expectations has moderated, the levels remain high. The data on the adjustment of the current account deficit show a slight improvement in millions of US dollars, but its level still requires adjusting, on which both the monetary and the fiscal policies must continue working.

The majority of the Board Members considered that it is appropriate to continue with the path of 25 bp increases. They highlighted the moderation observed in the increase of inflation expectations in February, which could be reinforced with a more stable exchange rate. Also, they opined that transmission of policy rate increases to the economy is operating effectively, and they expect it to continue doing so throughout this year. As for the external adjustment, they stressed that the value of the current account deficit in US dollars lowered in 2015 vis-à-vis the value in 2014; one of the Board members mentioned that the recent upturn in the price of oil could lead the current account deficit to be even lower in 2016 than initially projected. However, as long as there are external imbalances and a gap between inflation expectations and the goal, they consider necessary that domestic demand accentuate its deceleration process and that the monetary policy continues contributing to this adjustment.

The other Board Members proposed a 50 bp increase in the benchmark interest rate. They consider that there is a risk that, once the effects of the transitory shocks to prices have passed, inflation converges to a level higher than the target. This could be suggested by (i) the strong increase of core inflation indicators during the past 17 months, whose average has reached 6.1%; (ii) the activation of indexation mechanisms, with a figure for inflation of 6.77% by the end of 2015 and which posted at 7.6% in February this year; (iii) the existence of inflation expectations that, in the majority of its measurements, exceed the 3.0% goal and its control range (from 2.0% to 4.0%); and (iv) a higher-than-expected dynamism of domestic demand in an economy that shows excess spending over income, reflected in the large deficit in the current account of the balance of payments. This excess takes place in the context of an output gap close to zero and a benchmark interest rate that can hardly be assimilated to a contractionary policy stance. In their opinion, a path of stronger increases to the interest rates would have accelerated convergence of inflation expectations to the target, contributed to a greater reduction of the current account deficit, and allowed to end the cycle of increases of the interest rate earlier. Similarly, it would also have made it easier to achieve a more comfortable position to face future negative external shocks, in terms of having more controlled inflation expectations and less external vulnerability.

#### 3. POLICY DECISION

The Board of Directors of Banco de la República, by majority, decided to increase the benchmark interest rate by 25 bp to 6.5%.

Bogotá, D. C.