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Board of Directors

Banco de la República

Monetary Policy Report

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Monetary Policy Report

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I. External Context and Balance of Payments

1. In January, Colombia's terms of trade would have fallen again, mainly due to a new fall in the international prices of oil. To January 26, the price of Brent oil fell 17.6% on average, compared to the records of the previous month. This reduction is explained in large part by the prospect that in the next few months the excess supply would increase. This would come as a result of lifting restrictions on the export of oil by Iran together with the low probability that the countries of the Organization of Petroleum Exporting Countries (OPEC) restrict their production, along with some indications that global demand would have further moderated its pace of expansion. Additionally, there is still a high amount of global oil inventories.

2. The prices of nickel and other metals exported by some countries of the region also exhibited falls compared to observations from the previous month, as a result of the weak demand for these goods. In the meantime, the international price of coffee showed a reduction compared to December and remains at lower levels than those observed in the same period of 2015.

3. The most recent records of global economic activity confirm the low growth of Colombia's major trading partners for 2015 *vis-à-vis* observations from previous years.

4. In the United States, the figures of retail sales and consumer confidence to December remained favorable and suggest that private consumption continues to consolidate as the main engine of growth. In contrast, industrial production and exports continued to decline on a yearly basis. As for the labor market, employment creation indicators for December were high, with which the unemployment rate remained at 5.0%. Regarding the yearly variation in prices, there were some increases in the core inflation indicators (from 2.0% to 2.1%), and total inflation (from 0.5% to 0.7%), although the latter is still registering low levels.

5. The press release of the Federal Open Market Committee (FOMC) of the Federal Reserve (FED) suggested in its meeting of January that it would continue increasing its benchmark rate gradually along the year, although it suggested that the strength of the US dollar, low inflation and uncertainty about the global economic and financial scenario pose important risks for the normalization of the monetary policy.

6. In the euro zone, indicators of retail sales, industrial production and exports to December suggest that the economy would have continued to expand at a modest pace in the last quarter of 2015. Regarding the variation in prices, the indicators of total and core inflation in December did not exhibit significant changes and continue at low levels (0.2% and 0.9% on a yearly basis, respectively). In this context, the European Central Bank (ECB) hinted that it could increase its monetary stimulus by expanding already existing programs in the coming months.

7. In China, GDP growth for the fourth quarter of 2015 exhibited deceleration *vis-à-vis* the figure observed three months ago, moving from 6.9% to 6.8%. With this, growth for all 2015 was 6.9%, which is lower than in the previous year (7.3%) and the government's goal (7.0%). Additionally, the indicators of industrial production and fixed asset investment to December moderated their pace of expansion again. Yearly inflation in December remained low (1.6%). In this context, the Central Bank of China maintained an expansive monetary policy and allowed the depreciation of the yuan against the US dollar to continue.

8. In Latin America, the figures of real activity for November exhibit a mixed behavior. In the case of Peru, a slight recovery was observed compared to the first part of the year, while growth rates in Chile and Mexico continue with a low dynamism. On its part, the Brazilian economy would have deepened its recession.

9. For these economies, inflation records as of December exhibit a predominance of rising trends. Further increases were observed in Chile and Peru, remaining above the target range of their monetary authorities, which led to increases in their reference rates. On the other hand, inflation in Brazil continues high and with a marked upward trend. In contrast, Mexico exhibited further moderation in its yearly variation in prices, remaining below 3.0%. In spite of this, the Central Bank of Mexico increased its benchmark reference rate.

10. In the last few weeks, greater risk aversion in international financial markets was observed, mainly as a result of the prospects of a further weakening of emerging economies, especially China, capital outflows from these countries, and the new fall in the prices of commodities. In this context, the US dollar strengthened *vis-à-vis* most currencies in the world, and sharp falls in stock

indexes took place. Additionally, a reduction in the rates of long-term sovereign bonds of major developed economies was observed.

11. As for Latin America, risk premia have continued to increase during January, and continue at the highest levels since 2009 in Brazil, Colombia and Peru. The currencies in the region resumed their weakening trend *vis-à-vis* the US dollar. The Colombian peso depreciated 1.1%, moving from an average value of COP $3,248 per dollar in December to COP $3,285 per dollar to January 26.

a. Exports and Imports

12. In November 2015, total exports in US dollars recorded a yearly fall of 37.7%, explained by the decline in the value of exported mining goods (-48.2%), agricultural products (-17.0%), and other exports (-21.6%). The fall in mining goods is mainly associated with lower exports of oil (-56.8%) and refined goods (-48.1%). The group of agricultural goods recorded increases in the external sales of banana (17.2%) and flowers (3.1%), but exhibited a decrease in coffee exports (-29.7%).

13. Among other exports, the falls in food, beverages and tobacco (-27.8%), chemical products (-18.4%) and machinery and equipment (-44.6%) stand out. By destinations, the following falls in this group stand out: 60.2% to Venezuela; 33% to Ecuador; 19.2% to the European Union; 29.8 to Asia, and 17.1% to other destinations. Contrastingly, there was an increase in external sales of this group towards the United States (6.2%).

14. In the accumulated total of the year to November 2015, total exports fell 35.3%. This is explained by declines in external sales of mining goods (-46.8%), agricultural goods (-0.6%) and other products (-11.8%). The negative variation of exports of mining goods was mainly due to a lower value of oil exported (-50.4%), refined products (-58.5%), and coal (-32.5%). Among other exports, the falls in food and beverages (-16.2%), non-metallic minerals (-24.6%), and graphic arts (-17.5%) stand out. The slight drop in exports of agricultural goods is due to setbacks in the external sales of banana (-3.6%) and flowers (-5.9%).

15. In November, CIF imports in US dollars fell 20.8% on a yearly basis. This decline is associated with lower imports of capital goods (-26.3%),

intermediate goods (-13.8%) and consumer goods (-23.3%). As for import of capital goods, the fall is explained by capital goods for industry (-22.7%), construction materials (-5.1%), and transport equipment (-38.9%). Imports of intermediate goods decreased due to the fall in fuels and lubricants (-26.4%), raw materials for industry (-8.9%), and agricultural raw materials (-10.0%). Regarding consumer goods, the fall was due to the lower purchases of durable (-29.4%) and non-durable (-16.5%) goods.

16. To November 2015, CIF imports in US dollars fell 14.8%. This is explained by decreases in intermediate goods (-16.9%), capital goods (-12.7%) and consumption goods (-13.7%). The fall in intermediate goods is mainly associated with the 34.6% decline in fuels and lubricants, and of 11.1% in raw materials for industry. Within capital goods, the greatest contributions to the fall were those of capital goods for industry (-13.1%), transportation equipment (-13.1%), and construction materials (-9.7%). Imports of consumer durables had a variation of -19.5%, while those of non-durable goods fell -7.2%.

II. Projections of External Variables

a. External Growth Scenarios

Baseline or more likely scenario (Table 1)

17. Growth forecasts for 2016 for the country's main trading partners were revised downwards in the present report compared to the ones published in the previous quarterly report. Thus, the forecast of the average yearly GDP growth of Colombia's major trading partners (weighted by non-traditional trade) moved from 1.7% to 1.3%.

18. This revision was mainly due to the fact that Latin American economic performance for 2016 would be weaker than expected in the September Inflation Report. Chile, Mexico and Peru's recovery is expected to be slower, given that commodity prices would remain low and that demand on the part of its major trading partners would be modest. As for Brazil, the contraction of its economy would be deeper as a result of the loss of its investment grade and the low confidence levels of investors and consumers. Finally, Venezuela’s recession would continue as a consequence of the low international prices of oil.

19. In the case of the United States, the growth forecast for all 2016 was slightly revised downwards as a consequence of global uncertainty and the appreciation of the US dollar having a greater-than-expected effect on net exports and on non-residential investment. Despite this, expansion of this economy is expected to continue, supported by the good dynamism of private consumption, given that the fundamental factors remain favorable.

20. Inflation in the United States during 2016 would remain below the FED's long-term goal (2.0%), as a result of the new fall in the prices of commodities, especially fuels and of the strength of the US dollar. In this context, the FED would increase its reference rate very gradually along the year. This measure is expected to be transmitted in an orderly manner to the market rates.

21. As for the euro zone, recovery of the economy would continue taking place slowly, as expected in the previous Inflation Report. The measures taken by the ECB have allowed for the recovery of confidence and have restored the credit channel to some extent, which would encourage private consumption and investment. However, it is expected that exports outside the European Union do not boost growth in the region facing a weak global demand.

22. Inflationary pressures would remain contained during 2016 as a result of the low prices of fuels, scarce demand pressures, and modest inflation expectations. In this context, it cannot be ruled out that the ECB increase the existing measures of monetary stimulus.

23. As for China, growth is expected to continue its re-balancing process towards an economy supported by a greater dynamism of private consumption. Thus, exports and investment would continue moderating their growth rates from the high levels in previous years. In spite of this, there is confidence in that the government's and the central bank's stimulus measures would allow for a soft landing.

b. Exports e imports

Risks to the Baseline Scenario

24. A stronger slowdown in China associated with problems of financial stability.

25. The high level of debt in emerging countries, together with deterioration of their economic situation, greater external interest rates, and depreciation of their currencies could result in a solvency problem in some of these economies. This situation could spread to international financial markets.

26. Political uncertainty in the United States and the euro zone.

27. The new fall in the prices of commodities could affect the economic performance of the countries that export these goods more than expected.

28. Financial markets could overreact to the normalization of the monetary policy in the United States.

Table 1

Economic growth forecasts for Colombia's major trading partners

Country or region	2015			2016		
	Low	Baseline	High	Low	Baseline	High
US	2.3	2.5	2.7	1.8	2.5	2.8
Euro Zone	1.3	1.5	1.7	0.8	1.6	2.0
China	6.8	6.9	7.0	6.0	6.4	6.8
Brazil	-4.0	-3.7	-3.3	-3.5	-2.5	-2.0
Ecuador	-0.3	0.1	0.4	-2.0	-0.5	0.5
Venezuela	-10.0	-9.0	-8.0	-10.0	-5.0	-3.0
Peru	2.5	2.8	3.1	2.5	3.5	4.0
Mexico	2.2	2.4	2.6	2.0	2.8	3.3
Chile	1.9	2.1	2.3	1.0	2.5	3.5

c. Projection of the Balance of Payments

29. The deficit in the current account accumulated to the third quarter of 2015 was 6.6% of GDP (USD $14.469 m), greater than the one observed in the first three quarters of the previous year (4.7%, USD $13.222 m). This increase, as a percentage of GDP, is explained in 0.2 percentage points (pp) by the greater deficit in US dollars and in 1.7 pp by the effect of the depreciation of the peso in the measurement of nominal GDP in US dollars.

30. In the present report, the deficit in the current account for all of 2015 is estimated to be higher than foreseen in the last quarterly report (6.2%), remaining higher, as a percentage of GDP, than the one registered in 2014. Thus, in the most likely scenario, the current account deficit for the whole year would be around 6.5% of GDP (**Table 2**). This result reflects a reduction in the deficit in US dollars to $19,143 m (from USD $19,567 m in 2014), offset by a 1.8 pp valuation effect of GDP in US dollars, given the depreciation observed for the year on average (37.1%).

31. The larger deficit expected is associated mainly to the effects of the prolongation of the downward trend in the price of oil observed in the fourth quarter of the year on the trade balance, and the lower dynamism of trade with Venezuela and Ecuador in the second semester of the year.

32. In the fourth quarter, exports of goods have been affected again by the behavior of the international prices of commodities. In this period, the prices of oil, coffee, ferronickel and coal were below the estimations for the last quarter of the year, stressing the fall in traditional exports that had been forecast a quarter before. Thus, in the baseline scenario, exports of the main products would fall close to 42.0% (in US dollars).

33. Similarly, the forecast of exports of industrial products suggests a further contraction of these sales *vis-à-vis* the previous report, given that the fall in exports to Ecuador and Venezuela has been greater than expected, in addition to weak demand from the United States and other destinations.

34. On the other hand, a significant reduction in imports is expected in the fourth quarter due to a less-dynamic domestic demand versus last year and the generalized fall of the international prices of imported goods, especially intermediate goods (fuels and derivatives), a behavior observed with data from trade available to November.

35. Additionally, preliminary information published by DIAN suggests a significant reduction of imports in yearly terms in December (-24.9%), which confirms the trend observed along the year. Thus, a 21.4% annual contraction of imports is estimated for the fourth quarter, which implies a 15.4% reduction for all 2015.

36. The fall of external purchases will be accompanied by a lower deficit in the balance of services as a result of the positive effects of the exchange rate on this type of exports and the reduction of imports associated with freight services and tourism.

37. Similarly, lower net outflows by factor income are expected, given the fall in the profits of the mining and energy sector, and the effects of depreciation and economic slowdown on other sectors.

38. Considering this, the estimated current account deficit of 6.5% of GDP for 2015 implies an adjustment of the deficit in the last quarter of the year

(around 6.3% of GDP) due to the observed behavior of imports, the reduction of the deficit in services and income, and an additional contribution of current transfers due to the increase in remittances from workers observed in recent months.

Table 2

BALANCE OF PAYMENTS - (Millons of US dollars)	2014	2015 Baseline
CURRENT ACCOUNT (A+B+C+D)	**(19,567)**	**(19,130)**
Percentage of GDP	**(5.2)**	**(6.5)**
Percentage of GDP (Market Exchange Rate 2014)		**(4.7)**
A. Goods	**(4,598)**	**(14,075)**
a. Exports	57,012	38,025
Main products	41,019	23,808
Other exports	15,993	14,217
b. Imports	61,610	52,099
B. Non-factor Services	**(6,657)**	**(3,784)**
C. Factor Income	**(12,671)**	**(6,485)**
D. Current Transfers	**4,359**	**5,214**

39. In terms of financing, the flows of foreign direct investment towards the mining-energy sectors for the last quarter of 2015 are expected to be still lower than those observed so far to September, as a result of the outlook on prices. For other sectors, greater resources are estimated for the fourth quarter compared to observations from the previous quarter, but they would remain at low levels versus those from last year. Thus, for all 2015, a reduction in FDI of around 25.0% is estimated for Colombia.

40. On the other hand, portfolio investment or portfolio flows remain lower than those registered a year ago, when the indexes of emerging public debt by JP Morgan were recomposed favoring Colombian bonds. This has been partially offset by greater resources from other investments, particularly loans obtained by the non-financial public sector (**Table 3**).

Table 3

BALANCE OF PAYMENTS - (Millons of US$)	2014	2015 Baseline
CAPITAL AND FINANCIAL ACCOUNT (A+B+C+D+E)	**(19,903)**	**(19,633)**
A. Net Foreign Investment in Colombia	**(12,426)**	**(8,169)**
a. Foreign Investment in Colombia	16,325	12,111
b. Colombian Investment abroad	3,899	3,942
B. Portfolio Investment	**(11,654)**	**(7,232)**
a. Public sector	(15,428)	(6,428)
b. Private sector	3,774	(805)
C. Derivative Instruments	**268**	**1,482**
D. Other investment (loans and other credits)	**(528)**	**(6,126)**
a. Assets	1,820	(461)
b. Liabilities	2,348	5,665
E. Reserve Assets	**4,437**	**412**
ERRORS AND OMISSIONS	(335)	(504)
Financial Account without Reserve Assets	**(24,339)**	**(20,046)**

41. For 2016, a lower current-account deficit is foreseen, both in US dollars as well as relative to GDP (around 6.0%). This forecast incorporates the effect that the additional fall in the price of oil has on different accounts of the external balance, as well as the effects of a moderate deceleration of economic activity in Colombia. Therefore, it is estimated that the deficit in trade would continue to be important within the contraction of traditional exports, partially offset by the recovery of non-traditional exports and the reduction of imports.

42. Thus, the performance of external sales will be affected by lower price forecasts for all major export products (in the case of oil, an average price of US$35 per barrel is estimated for Brent oil). This would be partly offset by the recovery in exports of oil derivatives with the full operation of Reficar halfway through the year.

43. Additionally, a slight acceleration in the growth of external demand is assumed, explained particularly by the expected results for the non-oil trade partners. This, together with the expected depreciation of the Colombian peso, would spur external sales of industrial products.

44. Consequently, in the baseline scenario, exports of the main products would fall about 29.0%, while total exports in US dollars would contract 16.5%.

45. On the other hand, imports in US dollars would contract *vis-à-vis* observations from 2015 (-13.9% on a yearly basis), which is associated with: the depreciation of the peso; the significant reduction in external purchases of durable consumption goods and capital goods associated with the mining

industry-energy; a less-dynamic domestic demand; and the substitution of part of the imports of fuels with the entrance into operation of Reficar and additional reductions in the prices of imported goods, particularly intermediate goods.

46. For the deficit in the balance of services, an additional reduction versus the one observed in 2015 is projected, driven by the effects of depreciation on the net balance of some services such as business and tourism, and the reduction of prices of imported services such as cargo transport. A decrease in net outflows by factor income is also expected, associated particularly with lower remittances of profits from the mining and energy sector.

47. As for financing, capital flows are expected to be lower than those estimated for 2015, affected by the additional reductions in investment plans by the mining-energy sector and the lower estimated flows of foreign portfolio investment, in a context of better conditions for advanced economies and the continuation of the monetary normalization in the United States. Thus, net foreign direct investment is projected to be lower than the previous year, specially due to lower resources from FDI in the oil and mining sectors facing the sharp declines in the prices of these commodities, partially offset by a slight increase of flows towards other sectors resulting from the dynamism of infrastructure construction and resources from the sale of Isagen.

48. Lower net financing from portfolio investment resources is also expected compared to the previous year, given a lower estimate of foreign capital flows to the local public debt market and a decrease in the placement of bonds in international markets by both the public and private sectors. Additionally, resources from other investment (loans and deposits) would be reduced compared to those registered in 2015, particularly by the net indebtedness of the public sector.

49. Uncertainty about the conditions and availability of financing, as well as the sensitivity of some capital flows to the prospects of the mining-energy sector and economic activity in general, determine the forecast range for the current account deficit, which would stand between 5.4% and 6.5% of GDP.

III. Growth, Domestic Demand and Credit

50. The most recent information on the performance of real activity indicates that in the fourth quarter of 2015 the Colombian economy expanded at a pace similar to that recorded during the third quarter.

51. Between October and December, private consumption would have slowed down significantly as a result of the bad performance of spending on durable and semi-durable goods. Public consumption, on the other hand, would have exhibited low expansion, similar to that recorded on average for the first three quarters of the year. As for investment, expenditure on tradable capital goods (transport equipment and industrial machinery) would have deepened its fall, while construction of civil works would have contributed to output growth. Net exports would have contributed positively to economic growth, considering that real imports would have contracted at a higher pace than that of exports (consistent with the behavior of domestic demand for imports).

52. According to the Monthly Survey of Retail Trade (EMCM) by DANE, retail sales in November fell 0.7% compared to the same month in 2014 (-0.7% for the two-month period of October-November). This figure represented a deceleration *vis-à-vis* the records from the third quarter (4.3% on a yearly basis).

53. Results are better excluding vehicle sales. For the remaining aggregate value, the increase was 4.9% on a yearly basis in November (5.4% for the two-month period). Despite the better performance, a slowdown was observed with regard to data from the third quarter, when the series grew 8.3% on a yearly basis.

54. Motor vehicle sales registered sharp falls. In November, the index of vehicle sales fell 23.8% *vis-à-vis* the same month last year (-25.5% on a yearly basis for the two-month period of October-November), which represented a worse performance versus that of the third quarter (-10.5%). It should be noted that there is a high base of comparison for the same period of 2014, since the 14th *Salón del Automóvil* took place in Bogotá that month.

55. On the other hand, the data for vehicle licenses registered published by the Colombian Automotive Committee revealed a yearly reduction of 18.3% in November and 23.9% for the two-month period of October-November. Classified by end use of the vehicle, decreases took place within private use (consumption) and commercial use (investment), the latter being higher than the former.

56. Other auxiliary indicators that have a historically high correlation with the growth rate of private consumption produce mixed signals. On the one hand, the Consumer Confidence Index (CCI) for December fell compared to the records in October and November, and stood again at levels close to those observed in mid-2015, significantly below its average calculated from 2001. Thus, the average of CCI for the fourth quarter allows forecasting a mediocre performance of household consumption during that period.

57. Contrastingly, information from the Monthly Survey of Economic Expectations (EMEE) of *Banco de la República* to November indicates that private consumption would have recorded a good pace of expansion during the fourth quarter of 2015.

58. Additionally, the recent performance of employment indicators suggests that the labor market began to react gradually to the economic slowdown. In November, seasonally adjusted, the unemployment rate showed a slight upward trend. In spite of this, the number of employees showed some signs of recovery, led by the behavior of salaried workers. The estimates and forecasts of the technical staff show that the gap in the labor market would have turned positive during 2015, and that it would continue to expand further in 2016.

59. Regarding gross capital formation, the figures for imports of capital goods (in real terms) and the data for registers of working vehicles suggest that during the fourth quarter of 2015 the contraction of investment on machinery and equipment and transport equipment would have deepened. Contrastingly, investment in civil works would have contributed positively to GDP growth.

60. As for foreign trade, the figures for exports in US dollars published by DANE to November show significant setbacks. When expressed in constant pesos, falls of a lesser magnitude are also observed, although higher than those recorded in the third quarter.

61. Something similar would have happened with imports. The figures in US dollars also exhibited sharp contractions in October and November. When expressed in constant pesos, falls of significant magnitudes are also observed, even higher than those for exports. These stronger adjustments would have taken place with capital goods and durable consumption goods, consistent

with the behavior that the domestic demand for tradable goods would have shown during the fourth quarter.

62. On the supply side, uneven results were observed. Although there was a rebound in the industry and a significant increase in coffee production, the slowdown of trade and the fall of mining would subtract from output growth.

63. The indicators available for industry show a recovery of the sector. The yearly variation of the IIP (Index of Industrial Production) for November was 4.8%, from which the 17.4% increase of the sub-branch of oil refining stands out. Excluding this item, the remaining industries expanded 2.6% on a yearly basis. The trend components of both total industry as well as excluding refined products show an upward slope.

64. With information to December, the survey by Fedesarrollo exhibited a slight increase in the indicator of orders and a reduction of stocks, suggesting that the recovery would continue. However, expectations to three months fell. It should be noted that the volatility of the indicator of expectations has increased in the last year and the trend component remains stable, which makes it difficult to ascertain the direction of industrial sentiment. Industrial confidence in December improved compared to that in November.

65. Regarding the farming activity, with date to November, cattle slaughter showed a 2.9% expansion on a yearly basis. The October-November period accelerated *vis-à-vis* the third quarter (3.0% vs. 2.2%). On the other hand, with information to December, coffee production stood above one million 60-kg sacks (1,454,000), which implied a significant increase (33.9%). In quarterly terms, the fourth quarter has shown acceleration (25.6% vs. 14.7%). At the end of the year, production was 14,175,000 sacks, which represents a yearly increase of 16.8%.

66. As for construction, the few available indicators show mixed behaviors. While cement production accelerated in the October-November period versus the third quarter (8.0% vs. 5.3%), shipments decreased their pace of expansion (4.6% vs 7.5%). Construction licenses showed scarce growth in the accumulated twelve-month value to November (1.6%). It is worth highlighting that licensing of offices and commercial premises is contracting.

67. Regarding mining, oil production, although it improved as compared to the previous quarter, continued contracting during the fourth quarter of 2015

(1.1%). According to the National Hydrocarbons Agency (ANH), the production of oil in December stood at 993 thousand barrels per day. In all, the year's production was above 1 million barrels per day (1,003,000). As for coal, according to figures from the Colombian Mining Association, production so far this year to November stood at 72.3 million tonnes. This entailed a 1.5% fall *vis-à-vis* the same period last year. For the October-November period, yearly variation is -0.8%. It should be noted that these figures stand for 92.0% of the national production.

68. Finally, trade experienced a slowdown due to what has been mentioned before regarding retail sales and vehicle sales. Additionally, in the survey by Fedesarrollo, although traders reported mild improvements compared to November both in their perception of the current situation of the business and its future status, trend components exhibit deterioration.

69. Thus, industry and agriculture would be the most dynamic sectors in the fourth quarter. The mining sector would register a yearly contraction.

70. Finally, the real activity index (ISE) recorded a yearly 3.3% growth in October, a figure slightly above that observed for the aggregate of the third quarter (3.0%). In spite of this, information is still very preliminary to define a forecast of GDP growth based solely on this indicator.

71. Consequently, this information allows forecasting that yearly GDP growth for the fourth quarter would have registered between 2.6% and 3.6%, with 3.1% as the most likely figure. For all 2015, economic growth is projected at 3.0% within a range between 2.8% and 3.2%.

72. For 2016, the midpoint and the range of economic growth forecast were revised downward. In this report, the GDP growth rate is expected to post somewhere between 1.5% and 3.2%, with 2.7% as the most likely figure. The reduction in the baseline forecast is explained by a downward revision in the country's terms of trade, a lower external demand than the one planned a quarter before, and the increase of the country's risk premia, which implies a higher cost of external financing. At the domestic level, public consumption forecasts were reduced, and a lower purchasing power for households is expected. Regarding the range, it is biased downwards in order to take into account the risks faced by the growth of trading partners and the price of basic commodities, among others.

73. These forecasts assume that an important part of the effects of the shocks observed throughout 2015 would pass-through to demand in 2016.

IV. Behavior of Inflation and Prices

74. In December, once again annual consumer inflation rose significantly, exceeding the forecasts by market analysts and those by the technical staff at the Central Bank (**Table 4**). The figure for this month was 6.77%, 38 basis points (bp) higher than the records for November. The monthly variation was 0.62% versus the 0.54% forecast by market analysts.

75. As has been happening for some months now, in December the greatest inflationary pressures focused on the segments of food and tradables (excluding food and regulated items).

76. The average of core inflation indicators monitored by the *Banco de la República* continued its upward trend, closing at 5.43% in December. However, this time the increase was significantly lower (3 bp above the records for November) than the one observed in previous months. The current level is the highest since February 2009. While core 20 and CPI excluding food and regulated items fell, the CPI excluding primary food, fuels and public utilities and the CPI excluding food increased. The latter stood at 5.17%, i.e., 12 bp more than the data from November (**Table 4**).

Table 4

Inflation to December 2015

Description	Weight	Dec 2014	Mar 2015	June 2015	Oct 2015	Nov 2015	Dec 2015	Participation in monthly acceleration (%)	Participation in acceleration so far this year (%)
Total	**100.00**	**3.66**	**4.56**	**4.42**	**5.89**	**6.39**	**6.77**	**100.00**	**100.00**
Non-food Inflation	**71.79**	**3.26**	**3.46**	**3.72**	**4.75**	**5.05**	**5.17**	**23.04**	**43.73**
Tradables	26.00	2.03	3.46	4.17	6.42	6.92	7.09	**11.59**	37.82
Non-tradables	30.52	3.38	3.56	3.98	4.34	4.39	4.21	**(14.46)**	8.55
Regulated items	15.26	4.84	3.25	2.55	3.14	3.66	4.28	**25.91**	(2.64)
Food Inflation	**28.21**	**4.69**	**7.37**	**6.20**	**8.80**	**9.81**	**10.85**	**76.96**	**56.27**
Perishables	3.88	16.74	21.57	10.73	21.54	23.31	26.03	27.25	14.67
Processed food	16.26	2.54	5.99	6.00	7.39	8.56	9.62	42.66	34.65
Eating out	8.07	3.51	3.59	4.45	5.28	5.67	5.95	7.04	6.94
Core Inflation Indicators									
Non-food Inflation		3.26	3.46	3.72	4.75	5.05	5.17		
Core 20		3.42	3.70	4.24	4.94	5.23	5.22		
CPI excluding perishable foods, fuels and utilities		2.76	3.95	4.54	5.54	5.85	5.93		
Inflation excluding foods and regulated items		2.81	3.52	4.06	5.21	5.45	5.42		
Average of Core Inflation Indicators		**3.06**	**3.65**	**4.14**	**5.11**	**5.40**	**5.43**		

Source: DANE. Calculations by *Banco de la República*

77. Within the CPI excluding food, upward pressures came from regulated items and tradables, while the non-tradable component slowed down.

78. The increase in the yearly CPI for regulated items was considerable (3.66% in November to 4.28% in December) and focused on public utilities (water and electricity). In the first case, once again the increase resulted from the activation of indexation mechanisms contemplated by the regulation formula, according to which every time that inflation accumulates 3.0% since the last adjustment, a similar increase is allowed in the rates. As for energy, the increase would be explained by the higher generation costs at thermal plants due to *El Niño*.

79. The other two components of the CPI of regulated items (fuels and transport) did not register significant increases. The yearly variation of fuels remained negative (-7.35%) despite the accumulated depreciation of the peso as a result of the decreases decreed by the Government at the beginning of the year and by the decline in the international price of oil. Transport remained relatively stable at 3.3%; however, a significant rebound is expected in this item starting February 2016 as a result of the increases decreed in the rates of the public transportation system for Bogotá (*Transmilenio* and *SITP*).

80. Depreciation of the peso continued to generate increases in the tradable CPI excluding food and regulated items in December, as happened throughout the year. In this month, yearly variation of the CPI of this sub-group was 7.09%,

i.e., 17 bp above the records for November and 506 bp more than what had been observed in December 2014.

81. Since mid-2014 and until December 2015, the peso accumulated a 74.6% depreciation *vis-à-vis* the US dollar. In the same period, the tradable CPI excluding food and regulated items accumulated an 8.0% increase. Thus, at the end of 2015, pass-through of the depreciation of the peso to the tradable component of the CPI was close to 11.0%, higher than the one observed in the two preceding depreciation periods (2006 with 10.0%, and 2009 with 6.0%), but lower than the one recorded in 2003 (32.0%).

82. In recent months, increases have been widespread in the items comprised by this segment of the CPI. In December, particularly, the most significant increases were those in airfares, cleaners and disinfectants, detergents, vehicle tires, and orthopaedic devices, among others.

83. In December, the yearly CPI of non-tradables excluding food and regulated items fell to 4.2% from 4.4% a month ago, a figure below the expectations of the technical staff at *Banco de la República* (**Table 4**). The bulk of the decline was caused by the fall in the yearly variation in the CPI of entertainment services (soccer tickets) from 10.0% in November to 4.8% in December, given that the increases at the end of the year were lower than those observed a year ago. On the other hand, leases increased slightly (3.8%), as well as the CPI of the subgroup of items affected by the exchange rate (5.2%).

84. The activation of indexation mechanisms would be starting to affect a large part of non-tradable items, and would continue to do so during 2016, despite the fact that the estimates of the output gap by the technical staff at the Central Bank suggest that it would be negative for this year. Based on these estimates, it is considered that inflationary demand pressures were scarce for the end of 2015, and that they would continue to be so in 2016.

85. In December, food strongly continued pressing consumer inflation upwards. The yearly CPI of this component (10.9%) exceeded the projections of the technical staff at *Banco de la República*, and was 104 bp above the records for November.

86. This yearly two-digit variation reflects both the effects of *El Niño* and the depreciation of the exchange rate. The current event of *El Niño* weather

discouraged new sowing in farms and reduced the productivity of the crops, especially increasing the prices of perishable foodstuffs, which ended the year with a yearly 26.0% variation (**Table 4**). Also, the strong accumulated depreciation of the peso has pushed the prices of processed food (imported food or with a high percentage of imported materials), whose yearly growth rate was 9.6% in December. The yearly CPI of meals outside the home (6.0%) continued to rise in December, reflecting higher food prices, those of public utilities, and probably also the increase in leases.

87. The pressures in non-labor costs measured through the PPI increased again in November. Yearly inflation to producers of domestic supply (produced and consumed plus imported) rose from 8.94% in November to 9.57% in December. This behavior is explained by the pressures exerted by locally produced and consumed items, whose yearly variation rose from 5.7% in November to 6.0% in December. On the contrary, the yearly variation of the imported component of the PPI (18.0%) fell *vis-à-vis* that of the previous month (18.4%).

88. Regarding labor costs, with information to November and December, wages continue exhibiting yearly adjustments which were consistent with the inflation target range. Those for heavy construction (3.7%) and housing (4.2%) showed no significant changes during December. Those for retail trade, on the other hand, fell, registering 3.5% in November.

89. Inflation expectations for the end of 2016, obtained from the monthly survey to financial analysts which were collected at the beginning of January, registered 4.83%, while those of the quarterly survey of January 2016 stood at 5.35%. Inflation expectations to twelve months obtained from the same survey fell from 4.63% to 4.50%, while expectations to twenty-four months stepped from 3.83% to 3.68%. On average, so far to January 26, with the average data from December, implicit inflations (Break-even Inflation, BEI) embedded in sovereign bonds in pesos and UVR increased (10, 12, 14, and 11 bp) for all terms (2, 3, 5, and 10 years). Thus, the average BEI so far in January to 2, 3, 5 and 10 years posted at 4.91%, 4.74%, 4.67%, and 4.92%, respectively.