PUBLIC VERSION

Working Papers from the
Board of Directors
Banco de la República

Monetary Policy Report

Monetary Policy Report

Economic Studies Division

JANUARY

2017

I. External Context and Balance of Payments

1. The few data available suggest that growth of Colombia's trading partners for 2017 would continue being very modest, according to the forecast presented in the December Inflation Report.
2. In the United States, GDP in the fourth quarter of 2016 was relatively low, recording 1.9% QoQ AR. However, the monthly activity leading indicators suggest a greater growth for the first quarter of 2017.
3. Headline inflation in the United States posted at 2.5% annually in January, and it is expected to remain above 2.0% for the rest of 2017. Core inflation is also above the Fed's target (2.0%).
4. In this context, analysts assigned a probability greater than 50% for the Fed to increase its benchmark interest rate in the first half of 2017.
5. In the euro zone, GDP growth was 0.4% QoQ in the last three months of the year. In January, the indicators of consumer confidence and business activity keep the good behavior observed since the end of last year, which suggests that the economy would continue to expand during the first quarter.
6. Although in January headline inflation in the euro zone increased reaching 1.8% on a yearly basis, core inflation remains stable at 0.9%.
7. The European Central Bank does not seem to be contemplating changes in its policy rate or modification to its asset-purchase program.
8. In China, retail and the PMI for services and manufacturing continued to show increases in December and January. Fears persist in the face of a sharper economic slowdown and possible financial instabilities due to over-indebtedness of the economy.
9. In Latin America, the data available suggest that growth continues to be mediocre. Peru slowed down more than expected in the fourth quarter of 2016.
10. Inflation in Latin America exhibits a downward trend in most countries in the region, with only Chile standing close to its inflation target. In January, a significant increase in inflation was observed in Mexico due to the higher prices of gasoline and the accumulated depreciation.
11. Regarding the country's terms of trade, an increase is still expected in 2017 compared to 2016 and 2015, based on the expectations of higher prices of exports.
12. Oil prices have remained stable due to the implementation of the agreements of OPEC and the announcements of lower levels of production during the first half of 2017. However, the response of oil production in the United States to these measures is still to be seen, and could limit the magnitude of the increase in prices.

13. Since the elections in the United States, volatility indexes in the financial markets remain low. However, other indicators show that the markets are estimating a greater probability of extreme events taking place.
14. The rates of bonds in developed economies remain at levels higher than those observed last year. Additionally, so far in 2017, stock market indexes have exhibited an upward trend globally.
15. Risk premia in Latin America fell in the last few weeks, partly thanks to the higher prices of commodities. Colombia was not an exception.
16. In the last two months, capital inflows to emerging economies were observed, reversing the trend of the previous months. In December, these flows had been focused on fixed income, and in January on equity.
17. In this context, the year so far has exhibited an appreciation of the currencies of the region. This has been due, in part, to the rise in the price of commodities. To date, the only currency in the region that lost value compared to the levels prior to the US elections is the Mexican peso. Regarding the Colombian peso, to 22 February, it has appreciated 2.9% compared with the value registered at the end of 2016.

Exports (Table 1)

18. In December, the value of exports in US dollars registered a yearly 32.7% growth due to increases in mining goods (47.7%) and agricultural goods (69.2%). The increase was due mainly to the effect of prices (the index varied 23.8% annually versus 7.1% for the index of quantities), concentrated in the mining group (39.4% prices vs. 6.0% quantities). In the case of the group of agricultural products, the contribution was via quantities (42.7% quantities vs. 18.5% prices), with coffee exports standing out, reporting the historic maximum in both value and quantity (probably due to late registration and to an increase in sales caused by the need to comply with the contracts of the year, delayed by the trucking strike in June and July).
19. To date, exports have fallen 13.0% mainly as a result of the fall in the sales of mining goods (-18.4% on a yearly basis)
20. For 2016, the price index for total exports has registered a significant drop (-12.2%), while the volume index has fallen moderately (-1.4%). This would suggest that the value of exports fell mainly as a result of the reduction in prices, from which the most significant is that of mining products (-15.0% on a yearly basis to December). On the other hand, the increase of external sales of agricultural goods (0.4%) stands out, caused by an effect of quantities (the index increased 7.0% in the year, while prices fell 6.2%).

21. According to the preview for foreign trade by DIAN, in January 2017, exports excluding oil and its derivatives increased 26.3% on a yearly basis. (According to this source, they had also grown 26.3% in December; however, the increase reported later by DANE was 32.7%).

Table 1: Behavior of Exports in US dollars

	Annual Variation	Items that contributed the most to Annual Variation (same direction):		
		Item	Annual variation of the item	Contribution to Annual Variation
December 2016				
Total	32.7%			
Agricultural goods	69.2%	Coffee	99.1%	8.3
		Banana	40.5%	1.0
Mining goods	47.7%	Coal	67.2%	9.5
		Oil	25.6%	6.3
Other exports*	-1.9%	Chemical Products	-12.9%	-1.4
		Vehicles	-28.5%	-0.8
Accumulated value for January-December 2016				
Total	-13.0%			
Agricultural goods	0.4%	Banana	14.0%	0.3
Mining goods	-18.4%	Oil	-37.2%	-13.4
Other exports*	-8.7%	Chemical Products	-11.5%	-1.0
		Foods, Beverages, and Tobacco, excluding Coffee	-5.6%	-0.3

* Within this group, the destinations which contributed most to the fall were Venezuela, the US, and Perú, with annual reductions of 50.7%, 11.4%, and 13.6%, respectively.
Source: DANE

Imports (Table 2)

22. In December, CIF imports in US dollars registered an annual 2.8% fall due to setbacks of capital goods (-13.8%). On the contrary, consumer goods increased (20.2%). In the year, external purchases fell 16.9%.

23. The price index for total imports registered an 11.7% fall in the year, while the volume index fell 6.0%. This would indicate that, although the major cause is prices, imports were reduced also by an effect of quantities.

24. According to the preview for foreign trade by DIAN, CIF imports recorded an annual 0.2% fall in January. (According to this source, they would have fallen 4.8%; however, the decline reported later by DIAN was 2.8%).

Table 2: Behavior of Imports in US dollars

December 2016				
	Annual Variation	**Items that contributed the most to Annual Variation (same direction):**		
		Item	**Annual variation of the item**	**Contribution to Annual Variation**
Total	-2.8%			
Capital Goods	-13.8%	Transport Equipment	-47.2%	-3.8
		Industrial Machinery	-10.6%	-0.7
Raw materials	-5.2%	Fuels	-19.8%	-2.5
Consumer Goods	20.2%	Private Vehicles	28.7%	1.6
		Food Products	34.4%	1.2
Accumulated Value for January-December 2016				
Total	-16.9%			
Capital Goods	-27.1%	Transport Equipment	-55.1%	-3.6
		Industrial Machinery	-27.8%	-2.1
Raw materials	-12.7%	Fuels	-27.0%	-2.4
		Chemical and Pharmaceutical Products	-10.3%	-1.4
		Mining Products (for industry)	-13.8%	-1.1
Consumer Goods	-9.4%	Private Vehicles	-18.4%	-1.1

Source: DANE

II. Growth, Domestic Demand and Credit

25. The National Administrative Department of Statistics (DANE) published the figure for GDP for the fourth quarter and for all of 2016. The economic activity showed an annual increase of 1.6% in the last three months of the year, a figure slightly higher than expected in the last report. In quarterly terms, GDP grew by 1.0%, which implies a 4.0% QoQ AR increase. Per branches, the sectors with the highest growth rates during the fourth quarter were, in their order, financial services, construction, and agriculture. Mining showed a strong contraction for the sixth consecutive quarter, while transport, and electricity, gas and water remained weak (**Table 3**).

26. Although the technical staff's forecast for the fourth quarter (1.5%) was similar to the one observed (1.6%), the full year stood at 2.0%, which was higher than had been expected in the previous quarterly report (1.8%). This is explained by the upward revisions of GDP in the previous quarters.

27. By branch of activity, the sectors with the highest growth rates during the year were financial services and construction, while mining and transport exhibited contraction.

28. For the fourth quarter, industrial production (according to the IPI) expanded close to 1.4%, on average. However, excluding oil refining, the industry contracted on average by 0.6%. Thus, the aggregate was driven significantly by the dynamism of the sub-group of oil refining (which grew 11.2% in December and 13.4% in

the fourth quarter). This behavior was observed along the year. It is also important to note that the trend for total industry shows an upward slope, while that of the manufacturing excluding refining is flat.

Table 3

Real annual GDP growth per economic activity

Branch of activity	2015 Whole Year	2016 1st Q	2016 2nd Q	2016 3rd Q	2016 4th Q	2016 Whole Year
Farming, forestry, hunting and fishing	3.3%	0.0%	0.4%	-0.5%	2.0%	0.5%
Mining and quarrying	0.6%	-4.7%	-6.9%	-6.5%	-8.2%	-6.5%
Manufacturing	1.2%	4.3%	5.1%	1.5%	1.0%	3.0%
Electricity, gas and water	2.9%	2.9%	-0.7%	-1.3%	-0.5%	0.1%
Construction	3.9%	5.3%	0.8%	6.8%	3.5%	4.1%
Buildings	2.1%	10.9%	2.8%	11.0%	0.9%	6.0%
Civil works	5.4%	0.4%	-0.4%	1.9%	5.1%	2.4%
Retail, repairs, restaurants and hotels	4.1%	2.8%	1.9%	0.8%	1.6%	1.8%
Transportation, warehousing and communications	1.4%	0.9%	0.2%	-1.5%	-0.1%	-0.1%
Financial, real estate and corporate services	4.3%	5.0%	5.4%	4.4%	5.0%	5.0%
Social, community and personal services	2.9%	3.5%	3.2%	1.3%	0.9%	2.2%
Subtotal value added	3.0%	2.7%	2.2%	1.3%	1.5%	1.9%
Taxes minus subsidies	4.0%	1.3%	4.1%	0.4%	2.8%	2.2%
GROSS DOMESTIC PRODUCT	3.1%	2.6%	2.4%	1.2%	1.6%	2.0%

Source: DANE, calculations by *Banco de la República*

29. On the side of expenditure, the DANE will publish the figures on 1 March. The information available for the fourth quarter reaffirms what was presented in the previous report. Particularly, it foresees an acceleration in private consumption and a further contraction of investment, which would accumulate four consecutive quarters with negative growth rates. Net exports would have contributed to the expansion of the economy.

30. According to the results of the monthly retail survey (EMCM) by DANE, retail in December (excluding fuels) expanded 7.4% annually. The aggregate for the fourth quarter grew 5.0% compared to the same period of 2015, accelerating versus the records for the third quarter (-2.0%).

31. As in November, the good performance of sales was due to vehicle sales. In December, car sales increased 38.9% annually, registering a 4.3 p.p. contribution to total sales. The aggregate for the quarter grew 21.3% compared to the same period of 2015, significantly greater that the third quarter (-12.7%). Excluding vehicle sales, the remaining aggregate for the month grew 2.9% on a yearly basis. A 2.4% growth was registered for the quarter *vis-à-vis* the same period last year (vs. 0.1% in the third quarter). The largest contributions came from sales of home appliances and furniture and food. The increase in sales of cars and appliances in November and December could have been due to an advance of shopping facing the expectations of higher prices due to the increase in the VAT.

32. Regarding gross capital formation other than construction of buildings and civil works, in December the balance of investment expectations of the EMEE registered additional decreases and suggests that this item of the GDP would have continued to fall. The behavior of imports of capital goods (in constant pesos) showed something similar. This series registered new falls, although not higher than those in the third quarter of 2016.

33. Regarding investment in construction, the indicator of civil works registered a 3.9% annual growth in the fourth quarter, a result which is lower than expected. The major contributions took place in those related with roads and other civil engineering works. In contrast, constructions for mining showed a significant contraction, which offset the expansion of the remaining items.

34. On the other hand, according to the figures in US dollars for foreign trade by DANE, in the fourth quarter the trade deficit reduced. According to estimates by the Central Bank, this is also true when the series is in real pesos.

35. The information available for 2017 is still scarce. In January, the Consumer Confidence Index (ICC) by Fedesarrollo collapsed versus the final records at the end of last year, and reached a minimum in the history of the series. Both the component of economic conditions as well as the medium and long-term expectations fell.

36. January figures published by Fenalco and ANDI revealed an annual growth in the number of licenses (2.8%). It is worth noting that license plates for private use vehicles (durable consumption) fell 1.6% on a yearly basis, while those for commercial use (investment in transportation equipment) increased by 8.3%.

37. On the supply side, in January, coffee production stood at 1,275,000 60-kg sacks, which represented a 12.2% yearly expansion.

38. As for the industry, indicators of the survey by Fedesarrollo to January showed a slight improvement in orders. In contrast, the stocks indicator (counter-cyclical), and expectations to three months reported a less-favorable figure. The trend component of each of the series does not suggest changes, for which the manufacturing sector would continue showing a weak behavior. With all of this, the industrial confidence showed a slight deterioration and its trend component suggests that the weakening of the sector continues.

39. For 2017, GDP growth is still projected between 0.7% and 2.7%, with 2.0% as the most likely figure.

40. Finally, labor market figures to December show mild increases in the unemployment rate. The only reduction took place in rural areas, where the downward trend continues, while that of the thirteen areas continues with a slight upward trend due to stagnation of employment. Nationwide, the behavior of the series in the last year makes it difficult to identify its trend clearly. However, in

the moving quarter ending in December, an increase in salaried employment was observed, compared to the same period last year (for the thirteen areas).

III. Behavior of Inflation and Prices

41. Annual inflation in January 2017 was 5.47%, falling *vis-à-vis* December (5.75%). Since last July, when it reached 8.97%, annual inflation has been falling uninterruptedly **(Table 4)**.
42. Monthly variation was 1.02%, higher than expected both by the market (0.90%) and the technical staff at *Banco de la República*.
43. The available information suggests that during January part of the observed increase in consumer prices was due to the impact of the tax reform (by the change in the VAT, the *green tax* and the Liquor Act). According to the different estimation methods, the impact in that month would have been between 20 and 40 bp.
44. The fall in annual headline inflation in the last month was concentrated on the food CPI, excluding meals outside the home.
45. Core inflation (5.61%), measured by the average of the four indicators monitored by the Central Bank, did not exhibit any relevant changes in January. After reaching its recent ceiling in July 2016, (6.61%), this is the first time that this average does not drop.

Chart 4

Headline and Core Inflation - to January 2017

Description	Weight	Dec 2015	Sept 2016	Oct 2016	Nov 2016	Dec 2016	Jan 2017	Percentage of Participation in Monthly Slowdown
Headline inflation	**100.00**	**6.77**	**7.27**	**6.48**	**5.96**	**5.75**	**5.47**	**100.00**
Non-food inflation	**71.79**	**5.17**	**5.92**	**5.64**	**5.31**	**5.14**	**5.26**	**(21.87)**
Tradables	26.00	7.09	7.20	6.49	5.74	5.31	5.37	**(2.11)**
Non-tradables	30.52	4.21	4.85	4.81	4.83	4.85	4.83	**6.60**
Regulated items	15.26	4.28	6.19	6.07	5.64	5.44	5.93	**(26.37)**
Food inflation	**28.21**	**10.85**	**10.61**	**8.53**	**7.54**	**7.22**	**5.97**	**121.87**
Perishables	3.88	26.03	6.66	(2.18)	(4.94)	(6.63)	(10.15)	72.44
Processed food	16.26	9.62	12.56	11.75	10.89	10.74	9.38	73.39
Eating out	8.07	5.95	9.18	8.64	8.36	8.54	9.26	(23.96)
Core inflation indicators								
Non-food inflation			5.17	5.92	5.64	5.31	5.14	5.26
Core 20			5.22	6.73	6.58	6.33	6.18	6.18
CPI excluding perishable foods, fuel and utilities			5.93	6.65	6.37	6.08	6.03	5.95
CPI excluding food and regulated items			5.42	5.84	5.52	5.22	5.05	5.06
Average of core inflation indicators			**5.43**	**6.29**	**6.03**	**5.74**	**5.60**	**5.61**

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

46. In the last month, core inflation indicators exhibited a mixed behavior. The CPI excluding primary food, fuels, and public utilities was the only one that fell (from 6.03% to 5.95%). Contrastingly, the CPI excluding food increased from 5.14% to 5.26%. On the other hand, the CPI excluding food and regulated items (5.06%) and Core 20 (6.18%) remained stable **(Table 4)**.

47. Within the CPI excluding food, the annual adjustment of the group of tradables (excluding food and regulated items) increased slightly from 5.31% to 5.37% in January. This behavior could be explained because the impact of the tax reform offset the downside effect of the appreciation of the peso. According to estimates by the SGEE, the CPI for tradables excluding food and regulated items should be the segment most affected by the increase in indirect taxes.

48. On the other hand, the annual CPI adjustment in non-tradable items excluding food and regulated items in January (4.83%) was somewhat lower than in December (4.85%). As mentioned in the previous report, this segment has been fluctuating between 4.8% and 5.0% in the last twelve months. Such stability is associated with the prices of rents, whose annual variation in January (4.0%) was equal to that of December and similar to the one observed for over than a year. The sub-group of items affected by the exchange rate decreased (from 5.66% to 5.14%), while the segment of indexed items (education and health services, management of buildings, among others), with an annual 6.15% variation, exhibited few changes. On the contrary, the annual variation of the aggregate of remaining items (including soccer tickets) increased from 5.79% to 6.38%.

49. The CPI for regulated items stood at 5.93%, increasing 49 bp compared to December. This gain is explained by public utilities (from 6.08% to 6.35%) and fuels (1.83% to 4.27%). As for public utilities, the water rates increased in January more than 1.0%, and fuels increased more than 2.0% (supposedly, the carbon tax of COP $135 began to be charged since January). On its part, transport (6.07%) remained unchanged, although increases are anticipated given the different announcements on adjustments between 5% and 10% in the first few months of 2017 in various cities in the country.

50. Annual variation in food prices continued to decline, mainly as the shock caused by *El Niño* on perishable goods continued to dissipate. Thus, in this last month, the greatest fall was concentrated again in this subgroup (from -6.63% to -10.15%), thanks to the behavior of the prices of products such as potato, carrot, other tubers, and beans. In January, the annual CPI variation of processed foods also decreased (from 10.74% to 9.38%) mainly due to smaller adjustments in the prices of rice, salt, coffee, and chicken.

51. However, meals outside the home caused surprise again, increasing 9.26% in January compared to 8.54% in December. According to estimates by the technical staff, the impact of the tax reform would be very low in this case,

therefore the increase in the annual variation of this item would have to obey to other factors such as the adjustment of the minimum wage at 7.0%, or the increases in the price of meat (over 18% on a yearly basis in January).

52. The pressures of non-labor costs continued easing in January, according to the annual variation of the PPI for domestic supply (produced and consumed domestically, plus imported goods), which moved from 1.62% in December to 0.88% in January. Annual variations in the components of local PPI (3.23%) and imported (-4.17%) decreased 62 bp and 104 bp, respectively.

53. As for labor costs, the behavior was mixed. With information to December, the adjustment of wages for retail (6.89%) and industry (6.42%) remained unaltered, although significantly above the inflation target. On the contrary, with data to January, the wages for construction kept a pace of adjustment more compatible with the target: those for heavy construction 3.90% (compared to 4.29% in December) and those for housing construction 4.44% (versus 4.28% in the previous month). As mentioned in the past report, the increase in the minimum wage (7.0%) could exert some upward pressures on the CPI, although limited due to the current slack exhibited by the labor market.

54. According to the most recent monthly survey to financial analysts (applied at the beginning of February), inflation expectations to December 2017 increased from 4.51% in January to 4.61% in February. On the contrary, expectations to 12 months decreased from 4.25% to 4.09%, while those to twenty-four months (3.61%) showed no significant changes. Finally, those embedded in public debt bonds in pesos and UVR (Breakeven Inflation, BEI) on average to 22 February remained at levels similar to those of the previous month for 2, 3, and 5 year-terms, posting at 4.74%, 4.31%, and 3.82%, respectively.