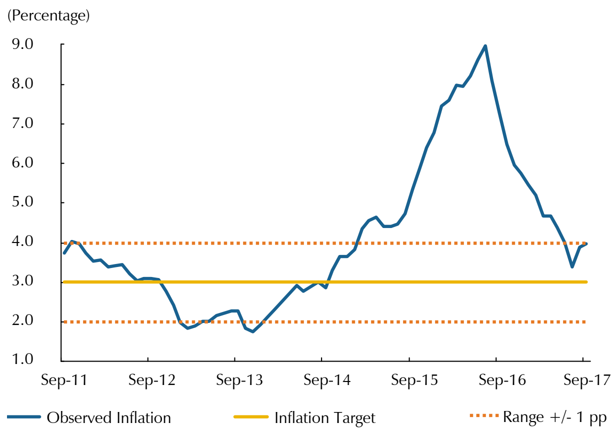
Inflation Developments and Monetary Policy Decisions

Graph A
Headline Consumer Inflation



Sources: DANE and Banco de la República.

After a year of continuous decline, inflation reached its lowest, (most recent) level in July (3.4%), and increased to 3.97% in September. Despite this, the figure was lower than expected by the market average and by the technical staff at *Banco de la República* (Graph A). The forecast error was mainly due to the favorable behavior of food prices and the rapid slowdown in the consumer price index (CPI) for tradable goods excluding food and regulated items. The yearly variation in prices of non-tradable goods excluding food and regulated items remained stable, although above the target. On the other hand, the CPI for regulated items accelerated due to the behavior of energy prices. Core inflation indicators, which do not incorporate the prices that respond to supply shocks or very volatile prices, continued to decline, reaching an average of 4.58% in September. The indexation of prices, the persistence of inflation, and the temporary effect of indirect taxes since the beginning of the year have slowed the convergence of these indicators to the target.

The short-term forecast by the technical staff of the Central Bank suggests that by the end of the year inflation will have reached a level close to the one recorded last September, and that in March 2018 it will fall to levels close to 3.4%. This forecast assumes that the effect of the value added tax (VAT) will have faded completely by March, and that the food supply will continue to be broad. It also implies that the prices of the most rigid goods and services (*i.e.*, education, leases, etc.) will be indexed to a much lower level than in the past two years. Inflation expectations also suggest that inflation would continue relatively stable in the remainder of the year, and that it will fall in 2018, although reaching levels above the 3.0% target. The October survey to financial analysts suggests that, to December 2017 and December 2018, inflation will stand at 4.07% and 3.58%, respectively. Inflation expectations embedded in public debt bonds to one and more years fluctuate between 3.5% and 3.6%. It is important that the negotiations on the minimum wage consider that favorable future behavior.

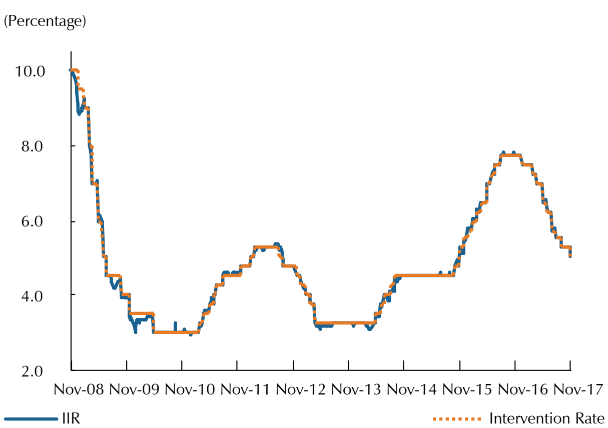
The behavior of the CPI as well as that of inflation expectations and forecasts takes place amidst a weak economic activity, which we believe will recover in the remainder of 2017 and (mainly) throughout 2018. The growth figures projected for the near future are, nevertheless, lower than potential GDP; therefore, the underused capacity of the economy (i.e., the output gap) is likely to continue expanding. The indicators for the third quarter suggest an acceleration of the pace of GDP growth, mainly driven by investment and, to a lesser extent, by public consumption, as well as by a low basis for comparison for the same period last year. With this, the technical staff at the Central Bank maintained its growth forecast for 2017 at 1.6%, within a range between 1.3% and 1.9%.

Several factors should affect the output in 2018. The reductions in policy interest rates carried out so far and a lower inflation should bring about a greater dynamics in household spending. Additionally, in 2018, investment would be driven by a larger execution of civil works. Foreign Direct Investment (FDI) in the oil sector would continue if the current levels of oil prices were to persist. Also, external demand will continue showing good signs, mainly driven by developed economies.
Some variables favor the external adjustment, but others will act in the opposite direction. In all, the estimates for the balance of payments in 2018 suggest a slight widening of the deficit in US dollars. As a proportion of GDP, it would reduce from 3.7% to 3.6%. On the one hand, external financing is expected to continue being ample in 2018, albeit more expensive, due to a less expansionary monetary stance in developed economies. The likely increase in global interest rates will possibly discourage the use of external savings as a source of financing. This, and the expected recovery of exports of goods and services, will contribute to narrow the current deficit. On the other hand, should investment in civil works and oil continue increasing, the demand for imported goods and services would increment, requiring more foreign financing. The latter and the higher payment of debt interest with non-residents would pressure to widen the current account deficit.
Considering the above-mentioned performance of domestic and international variables, the technical staff increased its growth forecast for 2018 from 2.4% to 2.7% (within a range between 1.5% and 3.5%). Downward risks in this projection remain significant. Again, as mentioned above, these forecasts will lead to a more negative output gap.

In all, forecasts for the second half of 2017 and 2018 suggest an acceleration of growth dynamics, although with rates lower than its potential. The excess capacity in the economy will expand, and would contribute to a fall of inflation. The short-term forecasts and inflation expectations suggest that inflation will continue falling, although at levels still over the target. The more rigid prices as well as wages are expected to be indexed to a lower inflation than in the previous years.
Based on this information, the Board considered the following factors for its recent decisions:

- The lower results of inflation versus the forecast from the last quarter, and the lower projections of the technical staff in the policy horizon. This behavior has been registered in several of the sub-groups of the CPI, particularly food and tradable goods excluding food and regulated items. These results suggest that convergence of inflation to its 3.0% target could be faster, although uncertainty in this regard remains high.
- Weakness in economic activity and the risk of a slowdown beyond what is compatible with the deterioration in the income dynamics due to the fall in oil prices. Despite the fact that the forecast of the technical staff for GDP growth increased for the coming year, the output gap would continue to expand.
- Although the orderly adjustment of the current account deficit is expected to continue, there are risks in the international environment that may affect such adjustment.

Graph B
Banco de la República's Benchmark Interest Rate and Interbank Interest Rate
(2009-2017)a/



a/ The figures correspond to data from working days; the last figure corresponds to 3 November 2017.
Sources: Office of the Financial Superintendent of Colombia and Banco de la República.

Upon assessing the risk balance and using the space associated with the best inflation forecasts for 2018, the Board of Directors considered it appropriate to reduce the benchmark interest rate 25 bp in each of its meetings in August and October, placing it at 5.0% (Graph B). The Board also pointed out that there are risks in the international environment that limit the countercyclical capacity of monetary policy in the future. Accordingly, the most recent reduction should not be understood as part of a continuous path of cuts.

Juan José Echavarría
Governor