[Detailed Explanation of the Macroeconomic Situation (only in Spanish)]

Must reads

[Banco de la República Lowers its Intervention Interest rate by 25 Basis Points]

A regular meeting of the Board of Directors of Banco de la República was held in the city of Bogotá D.C. on December 21, 2012. In attendance were Mr. Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit, Mr. José Darío Uribe, Governor and Managing Director of Banco de la República, and the full-time co-directors Messrs. Fernando Tenjo, Carlos Gustavo Cano, Juan José Echavarría, Juan Pablo Zárate and César Vallejo. Inflation and the economic situation were discussed with respect to growth and prospects for the future, and monetary-policy decisions were reached.

1. BACKGROUD

a. Recent developments in inflation

Annual consumer inflation declined in November for the third consecutive month and was at 2.77%, 29 basis points (bp) less than was registered the month before. Based on this information, the accumulated inflation over the course of the year is 2.34%. The annual change in the prices for the basket of food and the one excluding it showed significant reductions during this month.

In the case of the CPI for food, the annual variation dropped significantly in November. The change was 3.0%, which is 55 bp below what had been registered the previous month. This basket has been showing a declining trend with a few minor interruptions since the beginning of 2011. This was possible because of the positive performance of prices for perishables which saw an annual change of -1.95% during the month, a change that was 130 bp less than what was registered in October. There has also been a downswing in the annual variation of the CPI for processed food (3.12%) in the last few months. This has helped the aggregate's declining trend. Since June 2012, the reduction in the annual change has been 200 bp. Last of all, the annual change in the area of eating away from home declined 20 bp in the last month and was at 5.1%.

In the CPI excluding food, the bulk of the drop in the annual change in prices in November was concentrated in the basket of regulated items. The annual variation for this was at 2.8%, the lowest amount registered in the last three years. The drop in the price for fuel last month contributed significantly to this result. There was also a reduction in the annual adjustment of the CPI for public transportation in November. In utilities, there were monthly declines in the CPI for electricity and gas.

The other two components of the CPI excluding food –tradables and non-tradables– also showed reductions in the annual changes this last month although these were milder than the ones seen in the basket of regulated items. In the former, the annual variation was at 0.94%, which indicated a decline of 12 bp in comparison to what had been seen in October. Since June 2012, the annual change in this basket has been close to 1%. This result could be partly associated with the appreciation of the exchange rate.

The CPI for non-tradables excluding food and regulated items registered 3.97% in November, 6 bp less than what had been registered in October. This result could be due to the aggregate demand, which has seen a slowdown since midyear. This may have contained more pronounced price adjustments. It is noteworthy that the area of rentals, which has shown a growth trend for the last two years, showed a slight drop at this point (4 bp) and went to 3.9%. A few other services also presented a dropping annual change and contributed to the aggregate result.

Core inflation also fell this last month. The average of the four indicators of core inflation that are monitored by the Bank declined for the third consecutive month as it went from 3.11% in October to 2.96% in November.

The annual variation in the PPI remained in negative territory and continued dropping as it went to -1.6% in November. Part of this decline is due to agricultural prices, but it can also be seen in mining and manufacturing. The appreciation of the exchange rate and the lower international prices partly explain this phenomenon also.

According to the monthly survey of analysts at financial institutions, the inflation expected as of December of this year is 2.63% and that expected in 12 months is 3.12%. This represents a downswing in comparison to the results from last month. The expectations derived from the TES (with figures as of December 12) came to about 2.5% for the 2- to 5-year horizon. This is 40 to 50 bp lower than it was a month ago.

b. Growth

In the third quarter of 2012, the GDP expanded at an annual rate of 2.1%, which is below the lower limit of the range predicted in the September Inflation Report (between 3.3% and 4.8%). This figure indicates a significant slowdown in comparison to the economic growth in the second quarter (4.9%) and one that was more marked than expected. In quarterly terms, this means a drop of 0.7%, which is the first one in the last seven quarters.

By expenditure components, the slowdown appeared mostly in domestic demand and in exports also. In the case of the former, the annual growth was 2.4% compared to 7.1% in the second quarter. The lower growth of the GDP and of domestic demand originated from the area of gross fixed capital formation, specifically from the poor performance of investments in public works projects, construction and buildings, and transportation equipment. The results in these areas showed a significant contraction in annual terms that was not foreseen (-14.9%, -10.7%, and -10.9% respectively). With respect to public works, there were sharp drops in the investment in mining and in construction of highways and other roads. In investment in buildings, the lower outlays occurred in both housing and non-residential construction.

In contrast, the strength of private (4%) and public (4.8%) consumption in the third quarter was similar to what had been seen in the second and better than expected even when the growth of durable goods presented an annual contraction of 5.9% in the third quarter of 2012. Exports, which had grown at more than a real 11% in 2011, have been slowing down so far in 2012 and, in the third quarter, they grew 2.5%. This largely reflects the effect of the global slowdown on Colombia's foreign trade as well as the drops seen in the production of petroleum and coal in the third quarter due to supply shocks which will provisionally be transitory. Likewise, in line with the lower strength of domestic demand, the real growth of imports has declined from 21.5% in 2011 to 8.8% in the third quarter of 2012.

Regarding supply, in addition to the contraction in the branch of construction (public works projects and buildings), the stagnation of the industrial GDP (with an annual growth rate of -0.1%) as well as the very low growth in mining and quarrying (0.5%) stand out in the third quarter. The poor results for this latter branch contrast with its significant rate of expansion seen in the first half of this year (10.8%) and is the result of supply shocks in the production of oil and coal. Commerce, which is a branch that carries a lot of weight in the GDP, slowed from 4.3% in the second quarter to 3.7% in the third. The areas of transportation and financial GDP also presented slowdowns. In contrast, the GDP for not only agriculture but also social, community, and personal services surged.

With respect to the fourth quarter, the indicators available suggest that, in the area of private consumption, the performance will be similar to the one in the third quarter. The Fedesarrollo consumer confidence index remained above its historic average, which has been calculated since 2001, and was similar to what it was in September and October. In fact, the average so far in the fourth quarter surpassed what was seen in the third quarter. There was also a 22.4% increase in imports of consumer goods in dollars during October compared to the same month last year. This represents a sharp surge in comparison to the last few months. Last of all, bank loans for consumption, which had been dropping in previous months, did not do so in November. Rather, they grew at an annual rate (18.9%) that was similar to the rate registered in October. However, these results contrast with the indicator for total retail sales, which declined 0.3% annually (excluding cars, the dip was 0.2%). In September, the annual growth had been 2.3% (6.2% excluding automobiles). Uncertainty is high for public consumption and investment in public works projects, especially considering the high volatility that this series has been showing recently.

In October, Colombian exports in dollars grew 5.2% in comparison to the same month in 2011 (5.8% if the re-export of airplanes is included). This performance is due to the annual increases in the values shipped in the areas of industry and others (18%), agricultural goods (3.3%), and mining products (1.7%). Within these last two groups, the annual growth in exports of coal and flowers (38.6% and 16% respectively) stands out. In the industrial group, vehicles (73.6%), chemical products (10.4%), and food and beverages (10%) contributed the most to the growth of foreign sales.

Regarding supply indicators, industrial production for October grew at an annual rate of 1.2%. By sub-branches, the strongest ones were beverages (13.4%), vehicles (13.4%), other food products (11.1%), and milling and flour (7.3%). The most recent results of the Fedesarrollo business opinion survey of industry, which include information as of November, do not point to changes in the performance of the sector for the last two months of the year. Orders stopped showing additional drops and the level of inventory declined. Likewise, the index of business confidence maintained its downward trend but did not show additional drops. The Banco de la Republica's regional survey for October showed a similar trend in that it suggested that businessmen in industry had slightly improved their perception of the current sales while their outlook for the next 12 months continued to be less favorable. For commerce, the Fenalco and Fedesarrollo indicators show dissimilar signs. According to Fenalco, businessmen registered an improvement in their outlook with respect to the situation for current sales in November while their expectations continued to be unfavorable. However, Fedesarrollo's monthly survey suggested that both the current outlook and expectations for six months from now had improved in the last two months.

To summarize, the GDP data for the third quarter and the most recent numbers for the fourth quarter of 2012 suggest that the growth for the entire year could be less than 4%. The greater uncertainty in this forecast again goes back to the performance of investment, mainly the investment allocated to public works projects and building.

For 2013, some of the factors that have stopped investment in 2012 are expected to turn around thus driving domestic demand by this route. This is the case, for example, for some investment projects in the mining-energy sector which suffered delays this year. Something similar should be seen in the area of highway and other road construction. In addition, the conditions that support the strength seen in consumption and investment in machinery and equipment will continue in 2013. These include the stable levels of employment and consumer confidence and the reduction in policy interest rates in the second half of 2012, which are being transmitted to the lending interest rates.

c. Financial Variables

There was a pause in the moderate growth bank credit (N/C and F/C) had seen in November. Its annual rate of growth was 15.2%, which was 12 bp higher in comparison to the rate in October and 226 bp lower when it is compared to the rate in June.

This performance was seen in all the types of credit. The commercial loan portfolio in national currency registered an annual rise of 14.3% in November, which was slightly higher than the one seen the month before (14.1%) and lower than the rise seen in the first half of the year (16.9%). For the component in foreign currency, the annual growth was 5.8% thus continuing a limited recovery from the level seen in July (2%). The consumer loan portfolio likewise rallied a little between October (18.6%) and November (18.9%) but its growth was lower than that of June (22.2%). The mortgage loan portfolio, in turn, has shown a more stable performance with annual variations of 15.4% in November, 15.5% in October, and 16.4% in June.

The real interest rates (discounting the CPI excluding food) for the November disbursements of consumer loans was 15.4%; for mortgages, 10%; for ordinary commercial loans, 9.2%; and for preferential ones, 5.7%. These levels are below their respective historical averages as calculated since the year 2000. The real interest rates for loans granted through credit cards and for treasury bonds were at 26.7% and 5.5%. These rates are above the averages calculated since the year 2000.

d. Foreign Context

For the fourth quarter of 2012, the new information on developed countries shows that economic activity is weaker than what was expected. The Euro zone is still in recession and its largest economies (Germany and France) are showing signs of contraction while the United States is again showing signs of a slowdown. In the emerging countries, the new economic indicators for China suggest a recovery. Some indicators for Brazil point to its economic recovery continuing its slow rate of growth. In Chile and Peru, growth remains robust primarily based on their domestic demand.

Based on numbers from mid-December, the indices of manufacturing activity and services in the Euro zone remained in contracting territory while, in November, business and consumer confidence remained depressed. It is noteworthy that the weakness of the region does not belong exclusively to the economies on the periphery. Rather, the soundest countries in Europe, with Germany leading them, have been losing their buoyancy.

In the United States, in turn, some indicators of productive activity continue to show weakness. This is especially true in the case of retail sales and industrial activity, which are showing a virtual stagnation based on the figures for November. The uncertainty with respect to fiscal management has begun to affect consumer confidence in addition to the effect it is having on the investment decisions companies are making. On the positive side, the unemployment rate declined again in November and the housing market continues to show signs of recovery though still at a very low level.

In the case of the emerging economies in Asia, economic growth declined in the majority of the countries during the third quarter. However, based on the figures from November, retail sales and industrial activity in China surged again and this situation will contribute to the recovery of the region's performance.

In Latin America, growth in the third quarter surged in Brazil, Chile, and Peru while Mexico and Venezuela maintained their favorable rate. In spite of the fact that the growth of the Brazilian economy was higher, it was still much lower than the analysts expected. This situation raised the risk perception of that country a little.

Regarding the international prices for commodities, the prices for petroleum have remained below what was seen in the first half of the year but relatively high in historical terms. The prices for coffee continued their downward trend. Thus, even though the terms of trade for November are lower than those seen at the beginning of the year, they are still historically high and contribute to the support of Colombia's income. The terms of trade are expected to be relatively stable for 2013.

The lower international prices for commodities together with the slowdown in demand, primarily in developed countries, have contributed to the reduction of inflation in those countries. Likewise, in Latin America, with the exception of Brazil, prices have maintained a downward trend in the last few months. In the case of the Asian economies, no common trend can be seen.

The low inflationary pressures and a negative output gap have allowed the central banks in developed countries to keep their interest rates close to zero. In the emerging economies, the benchmark interest rates are at about their natural point. These situations are not expected to change in 2013 as a result of which, the abundance of international liquidity will continue.

The risks that weigh on the global economy for 2013 are still the same ones identified in the previous minutes and are centered around the fiscal quandary in the US and in the unfolding of the European situation. The possibility exists that the fiscal stimulus in China will favor greater growth in that country and help to offset a weaker trend in Europe and the United States.

Considering all of the above, it is feasible that the average growth of Colombia's trading partners could be somewhat weaker in 2013 than what was estimated before even though an amount that is higher than the growth in 2012 is still being predicted.

2. DISCUSSION AND POLICY OPTIONS

The board members' main points of discussion focused on the following aspects:

(i) The growth of the GDP for the third quarter in 2012 (2.1%) was below the range projected by the technical team at the Banco de la Republica (between 3.3% and 4.8%). Domestic demand slowed down significantly from 7.1% in the second quarter to 2.4% in the third. All of this is due to a sharp and unexpected tightening of investment, especially investment in public works projects and buildings. In public works, there were large reductions in investment in mining and in highway and other road construction. With respect to investment in buildings, the drop occurred in both housing and non-residential buildings.

(ii) In contrast, the strength of private (4%) and public (4.8%) consumption in the third quarter was similar to what had been seen in the second and a little better than had been expected. This was in spite of the fact that the growth of durable goods showed an annual contraction of 5.9% in the third quarter of 2012. Exports, in turn, which had grown at above a real 11% in 2011, have been slowing down over the course of 2012 and, in the third quarter, grew 2.5%. This reflects to a large degree the effect of the global slowdown on Colombian foreign trade. Likewise, the real growth of imports has dropped from 21.5% in 2011 to 8.8% in the third quarter of 2012 and this is consistent with the lower strength of domestic demand.

(iii) Recent data on the worldwide economy has not changed much from what was reported in the press release from the last Board meeting. International uncertainty has stayed the same. Some international economic indicators have improved a little. The weakness of a large number of industrialized economies and the lack of inflationary pressure makes it possible to expect foreign interest rates to remain low for a prolonged period of time.

(iv) The previous results and the new economic figures from the fourth quarter of 2012 suggest that growth for the entire year could be lower than 4%. The greater uncertainty in this forecast again originates from the behavior of investment, mainly that allocated to public works and buildings.

(v) Some of the factors that have stopped investment in 2012 are expected to turn around in 2013 thus driving domestic demand by this route. This, for example, is the case with some of the investment projects in the mining-energy sector which have suffered delays this year. Something similar should be seen in the area of highway construction and construction of other roads. In addition, the conditions that support the strength seen in consumption and in the investment in machinery and equipment will continue in 2013. These include, the stable levels of employment and consumer confidence and the reduction in policy interest rates in the second half of 2012. The latter are being transmitted to the lending interest rates. Last of all, in the foreign context, a growth of the worldwide economy that is slightly above what was registered in 2012, terms of trade that are relatively stable, and abundant international liquidity are anticipated. Under these conditions, economic growth in 2013 that is higher than what was projected for this year is expected.

(vi) The results of inflation in November were lower than expected. This was mainly due to the performance of regulated and food prices. Inflation, the average of the core inflation indicators, and the majority of the measurements of inflation expectations are below the target of 3%. With the new information available, this situation is anticipated to stay the same for a period of time.

(vii) In November, there was a pause in the moderate growth bank loans (N/C and F/C) have seen. Their annual rate of growth was 15.2%, which is 12 bp higher than it was in October and 226 bp lower when it is compared to the rate in June. This performance was seen in all the types of credit. The commercial loan portfolio in national currency registered an annual rise of 14.3% in November, which is slightly higher than the one seen the month before (14.1%) and lower than the rise seen in the first half of the year (16.9%). For the component in foreign currency, the annual growth was 5.8% thus continuing a limited recovery from the level seen in July (2%). The consumer loan portfolio likewise rallied a little between October (18.6%) and November (18.9%) but its growth was lower than that of June (22.2%). The mortgage loan portfolio, in turn, has shown a more stable performance with annual variations of 15.4% in November, 15.5% in October, and 16.4% in June.

The majority of the board members thought it would be appropriate to reduce the benchmark interest rate 25 bp considering the new information on various fronts. On the one hand, based on the data from November, both the inflation currently observed and that forecast for three quarters from now are below the long term target in a context in which no inflationary pressure can be seen from higher costs or climatic factors. On the other, the data with respect to the growth of the GDP for the third quarter points to a sharper than expected slowdown in economic activity which indicates the possibility of excess productive capacity (negative output gap). The reasons for this sharper slowdown in the economy could be blamed on problems that have been well-defined. As is well-known, external conditions have been negatively affecting international commerce and the prices of exported goods for several quarters. Even if these prices remain at historically high levels, they are lower than the ones registered in the first half of the year. More recently, a slump in domestic demand mainly associated with the contraction of investment in public works and in housing and non-residential construction has been added to this. This tightening is largely explained by exogenous factors that are administrative and regulatory in type and that could be overcome, although only partially, in the short term. Finally, even if the growth of the loan portfolio has stabilized at relatively high levels, these levels could be more a reflection of greater financial deepening in the economy than excessive indebtedness on the part of the agents.

Other members underlined the fact that almost all the indicators on the economy's progress indicate it is obviously deteriorating: industry is contracting (with a negative growth of -0.1% in the third quarter) in the midst of a sharp fall in the rate of growth of domestic demand for nationally produced products. These include specifically the iron and steel, textile, clothing, shoe, leather manufacturing, processed food sectors, etc. which are showing the effects of obvious weakness. In addition, a migration from national production to sales of imported goods can be seen, especially clothing, shoes, and manufactured leather products. Commerce is seeing mediocre growth driven mainly by the imports of consumer goods. The growth rates of large scale mining are dropping considerably and construction is evidently contracting. Leading indicators such as consumption of durable goods and investment in housing showed negative growth rates in the third quarter. On the international plane, demand in general continues its slowdown. In Asia, China has some signs of recovery but India and South Korea, etc. are losing strength. In Europe, the strong economies are being infected by those on the periphery and confidence is dropping. In the United States, exports continue to weaken. In Latin America, even though the strength of growth in Chile and Peru is remaining steady, Brazil will only grow about 1% this year. In conclusion, the slowdown in the economy is much stronger than it was expected to be and the output gap has probably gone into negative territory. Regarding inflation, no risk is seen in the medium term – overall it fell to 2.77%. The average for core inflation was below the mid-point of the target range for the first time. Inflation excluding food was at 2.68%. Inflation for food declined to 3.1%. Every day it becomes more probable that the Niño phenomenon will not occur this coming year. All inflation expectations also declined. The expectations for inflation excluding food 12 months from now fell to 2.8% and, in the area of agricultural commodities on the international level, prices are generally receding. Finally, a significant slowdown in the strength of credit can be seen. As a consequence, they proposed that the benchmark interest rate be reduced 50 basis points.

Another co-director stated that even if the data from the GDP, private demand, and inflation make it possible to predict the existence of a moderate excess of installed capacity, this is not the only variable that should be taken into account when establishing the posture of monetary policy. The different agents in the productive sector, especially households, show elevated levels of leverage that, fortunately, have been declining over the last six months. A benchmark interest rate that is well below the long term interest rate could reverse this adjustment process (which the figures that are available from last month are beginning to hint at) and increase the vulnerability of the productive sector. The current benchmark interest rate is low in historical terms and additional reductions would move it even further away from a rate that could be considered neutral for an economy that has not suffered financial crises nor generalized bankruptcies in the productive sector in the recent past. To conclude, the current policy posture is expansionary and suitable for alleviating a moderate output gap without exacerbating the vulnerabilities of the productive sector.

3. POLICY DECISION

Based on the evaluation of the balance of risks, the majority on the Board of Directors decided it would be suitable to reduce the benchmark interest rate to 4.25%.

The Board reiterates that the Banco de la Republica has sufficient tools and resources to cover liquidity needs in the national and foreign currency that the economy regularly requires and those that could appear in an environment of international financial turbulence.

The Board will continue to monitor the performance and projections for economic activity and inflation in the country, the asset markets, and international situation carefully. Finally, they reiterate that the monetary policy will depend on the new information available.