Monetary Policy Report

A regular meeting of the Board of Directors of *Banco de la República* took place in the city of Bogotá D.C. on Friday, October 28, 2016. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; Hernando Vargas, Deputy Governor of the Central Bank; and co-directors Carlos Gustavo Cano Sanz, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, Cesar Vallejo Mejia, and Juan Pablo Zárate Perdomo.

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

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

1. MACROECONOMIC CONTEXT

1. The growth forecast of Colombia's main trading partners for 2016 was revised downwards in this report, specifically that for the United States and some economies in the region. For 2017, a growth rate similar to the one presented in the previous quarterly report is foreseen for the country's trading partners, showing a slight recovery compared to 2016. Thus, the momentum generated by external demand for the Colombian economy will be somewhat higher, but still weak, next year.

2. For the remainder of the year and 2017, the terms of trade are expected to continue rising, largely due to the projected increase in the international prices of the main export products. However, the levels will remain below those of 2014.

3. Regarding external financing, no significant increases are expected for the remainder of the year and 2017. This implies that the normalization of monetary policy in the United States would be very gradual, and that the monetary policy stance of other developed countries will remain highly expansive. However, there are upside risks on account of an increase in risk aversion, in the perception of the country's risk, or by higher-than-expected increases in foreign interest rates.

4. The external deficit of the country has been correcting during this year, and this trend is expected to continue in 2017. As has been observed so far, the trade balance (goods and non-factor services) would have contributed mostly to the adjustment of the external imbalance. For 2016, the deficit in the current account is estimated to be close to 4.7% of GDP, and around 3.7% for 2017. These levels are still higher than the historical average registered in the country.

5. The reduction in the current account deficit and the slowdown of the Colombian economy reflect the adjustment required in the economy due to the negative shock to national income that the country has been facing since mid 2014. This slowdown has been slightly higher than anticipated in the Quarterly Report of June, partly due to negative supply shocks (trucking strike), whose effects in some sectors could not be offset in the following months.

6. Thus, the technical staff reviewed the growth projection downwards for 2016. For the whole year, GDP growth is expected to be 2.0%, within a range of 1.5% and 2.5% (versus 2.3%, within a range between 1.5% and 3.0% in the June report). For 2017, growth is estimated to be between 1.0% and 3.0%, with 2.0% as the most likely figure.

7. Consumer inflation has slowed down significantly in the last two months (from 8.97% in July to 7.27% in September), and has remained below the Central Bank's and the market's expectations. This suggests that the strong transitory shocks that diverted inflation from its target are beginning to fade at a pace faster than

expected. However, the measures for core inflation remain high, inflation expectations are above 3.5%, and in some cases exhibited slight increases in the last month.

8. Given the deterioration of national income due to the fall in the price of oil, a structural tax reform that improves government income should contribute to sustained growth in the long term by reducing the risk on the country, to improve the prospects for investment, and, in general, to macroeconomic stability in the country. However, the central forecasts in this report do not include the effects of said reform.

In all, the Colombian economy continues to adjust to the strong shocks recorded since 2014, and the current account deficit is narrowing gradually. The dynamism of output has been weaker than projected, inflation has lowered, but inflation expectations exceed the target. The effects of the transitory supply shocks that have affected inflation and inflation expectations have begun to reverse, and this trend is expected to continue. In this context, the monetary policy actions undertaken so far contribute to the convergence of inflation to its target.

2. DISCUSSION AND POLICY OPTIONS

After analyzing the most recent information on the Colombian economy and its prospects, all the members of the Board agreed to maintain the benchmark interest rate unaltered.

In general, the Board Members agreed with the analysis by the technical staff according to which the adjustment has been faster than anticipated, particularly in regards to the current account deficit, although an additional reduction is still needed. Furthermore, they highlighted the fact that inflation measures excluding food and excluding food and regulated items have decreased, as also have the monthly core inflation indicators, although they are still high.

Regarding the financial market, they also pointed out that there is a deceleration of the loan portfolio, particularly the commercial one. However, they stated that stability of rates is still required inasmuch as there is a need for a stronger anchoring of expectations to the target.

Some Board Members added that, according to the models and without considering yet the effects of the tax reform, there is still a high risk of not reaching the upper limit of the target range in 2017. For this reason, convergence of inflation to the target range at the end of that year is currently the main challenge for the monetary policy, following the commitment of the Board reiterated in November 2015. As for inflation, inflation expectations, and economic growth, the most recent data show that monetary policy measures taken in the past year have been producing the expected adjustment in the economy and in prices.

As for growth, some stressed that, in spite of the low growth of external demand, the exchange rate adjustment would cause net exports to contribute positively to growth. Both the increase in the terms of trade and the forecasts for the price of oil in 2017 will enhance the impact of the external sector on growth.

A member of the Board added that the latest data available show an indisputable contraction of the economy in the absence of fiscal, monetary, and external stimuli. It is possible that potential GDP growth has declined. However, it is very likely that such growth be higher than the 2.0% forecast by the technical staff at the Central Bank, for which the economy could be growing faster without generating inflation. Based on this, the monetary policy stance could be modified, but this is not possible because current inflation is 7.0%, and the models forecast inflation to be above 6.0% by the end of 2016, and close to 4.0% in 2017, which justifies not changing it. Considering risk, the current orthodox monetary policy stance provides insurance, improves confidence, and allows for capital flow. However, s/he invited the Board to approach future monetary policy analysis in terms of growth.

3. POLICY DECISION

The Board of Directors decided to maintain the benchmark interest rate unaltered at 7.75%.

The decision to maintain the benchmark interest rate unaltered was reached unanimously.