Monetary Policy Report

Must reads

Banco de la República reiterates the 3.0% Inflation Target and reduces the Benchmark Interest Rate by 25 bp to 4.75%

A regular meeting of the Board of Directors of *Banco de la República* took place in the city of Bogotá D.C. on Friday, November 24, 2017. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; Juan José Echavarría, Governor of the Central Bank; and Board Members Gerardo Hernández Correa, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, José Antonio Ocampo Gaviria, 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 the Central Bank will be presented in the monthly **Monetary Policy Report for October 2017** and in the statistical annex (Only Available in Spanish).

1. MACROECONOMIC CONTEXT

1. The GDP growth of the third quarter of the year (2.0% on a yearly basis) was below the expectations of the technical staff of the Central Bank. This implied a 0.8% increase between quarters, which corresponds to an annualized 3.2% increase.
2. Domestic demand grew by 1.6% *vis-à-vis* the same period in 2016, below the figure registered in the second quarter (1.9%). By components, the slowdown is explained by a lower dynamism of gross capital formation, while total consumption grew at rates similar to those in the previous quarter.
3. By branches of activity, the sectors that continue contributing the most to growth in this quarter were agriculture and financial services. In contrast, mining, building construction and industry showed significant contractions.

4. The information available for the fourth quarter is still scarce; however, some indicators suggest that the performance of economic activity during said period shall be slightly inferior to that observed in the third quarter, but superior to the figures from the first half of the year.
5. Regarding the labor market, the information to September shows increases in the unemployment rate on a national level and for the thirteen most important metropolitan areas. For this last geographic domain, the unemployment rate completed more than a year with an upward trend.
6. Nominal credit growth accelerated slightly in October (7.4%), driven by the recovery in the commercial portfolio. However, this behavior was explained by specific factors that are not associated with signs of recovery of companies´ credit demand. On the other hand, the slowdown in household credit continues.
7. Interest rates on commercial loans have registered drops greater than or equal to the change of the policy rate. In September, the transmission toward households' interest rates on loans continued as it has been the case since April of this year; the reduction in the rate for housing purchase also stands out.
8. Regarding the external context, the global economy would have continued its recovery, driven mainly by advanced economies. Particularly, the US and the euro zone economies exhibited greater growth than was expected for the third quarter. Furthermore, the region´s partners continue showing some recovery in their economic activity.
9. In the last weeks, oil prices have remained relatively high compared to the average observed so far this year, due to the better outlook for global demand. Thus, Colombia´s terms of trade to September remain at levels above the average level of 2016.
10. With all the above, some downside risks on the growth forecast for 2017, which was estimated at 1.6% in the previous Report, would be materializing.
11. Inflation to October increased, although below the expectations of the technical staff and the market, standing at 4.05% on a yearly basis. This corresponds to the third consecutive increase since July 2016. The group of perishable foods mainly contributed to this increase. Conversely, the groups of tradables (excluding food and regulated items), regulated, processed foods, and meals outside the home pushed annual inflation down. On the other hand, the average of the four core inflation indicators continued with the downward trend observed in recent months.
12. Inflation expectations for December of 2017, obtained from the monthly survey to financial analysts, were reduced, and stood at 3.95%. Analysts' expectations and those embedded in public debt bonds to horizons greater than or equal to one year remain stable, standing between 3.2% and 3.6%.

In summary, to December 2017, inflation is expected to finish slightly below 4.0% and decline in the first quarter next year, partly as a result of the reversal of the transitory shocks that have diverted it from its target. This takes place in an environment of economic activity that is weaker than expected. Monetary policy actions undertaken so far, which consider these effects, should strengthen convergence of inflation to its target.

2. DISCUSSION AND POLICY OPTIONS

The Board of Directors highlighted the decreasing trend of inflation. This behavior has been better in the last months than the forecasts of the Central Bank´s technical staff, and than the market´s expectations. On the other hand, core inflation exhibited a systematic decline during almost the entire year. Furthermore, the technical staff´s forecasts indicate that in December inflation will post below 4.0% and there is a high probability that next year it reaches its 3.0% target. Conversely, data on the productive activity show that, although the economy is in a reactivation process, it is still very slow and far from the potential rate of GDP growth. Additionally, the external accounts show an improvement, owing both to the increase in the prices of commodities and to the already positive growth of the volume of exports, including non-mining products and services.

Five of the seven Board Members voted for an additional reduction of the benchmark interest rate by 25 bp. This outlook recognizes that inflation is moving in the direction of reaching the Central Bank´s target, and there is a slight improvement in the external gap, although there is still a significant expansion of the output gap. This is due, above all, to the weakness of domestic demand, as is reflected in the growth reduction of said variable in the third quarter *vis-à-vis* the second quarter, and the weakness that consumer surveys reveal to the industry and to commerce in the available data for the current quarter.

The other two members voted to maintain the policy rate unaltered. In their judgment, this outlook is consistent with what was announced during the last Board meeting that the 25 bp reduction should not be understood as a continuous path of cuts. Moreover, they highlighted that there is still uncertainty regarding the forecasted fall in inflation for the first months of 2018.

3. POLICY DECISION

The Board of Directors of the Central Bank of Colombia decided to reduce the benchmark interest rate by 25 bp to 4.75%.

The decision to reduce the benchmark interest rate was approved by five (5) members of the Board. The two (2) remaining Board Members voted to maintain the policy rate unaltered at 5.0%.

Bogotá, D. C.