Inflation Report for the 1st Quarter of 2019

Inflation Developments and Monetary Policy Decisions

In the first quarter of 2019, inflation and core inflation indicators fell more than had been forecast in the previous Report, and remained close to the 3.0% target. Inflation expectations at different horizons decreased slightly and stand around observed inflation. The new figures for economic activity suggest that economic growth is still recovering from product levels lower than the country's natural output level. The current monetary policy stance is slightly expansionary.

In March, inflation stood at 3.21% and the average of core inflation indicators is 2.82%. These figures are lower than was expected a quarter ago and close to the 3.0% inflation target. The lower actual inflation versus the forecast is explained mainly by tradables (0.9%) and non-tradables excluding food and regulated items (3.29%). Factors such as the scarce pass-through of the depreciation of the peso to domestic prices, the indexation of some prices to inflation last December (3.18%), and the spare capacity of the economy explain much of this behavior. Similar to the expectations, the food CPI (3.26%) continued to accelerate, especially due to the group of perishable goods. On the contrary, regulated items (6.42%) increased more than had been projected due to the increase in the rates for public utilities.

With this context, inflation expectations declined slightly in April 2019. Those of analysts to different horizons ranged between 3.25% and 3.28%, and those embedded in public debt bonds to two, three, five, and ten years stood between 3.0% and 3.5%.

The behavior of inflation and inflation expectations in the first quarter of 2019 took place in a context of negative output gap, with a domestic demand that would have continued to recover, thanks to the behavior of public spending and investment, mainly in civil works. Foreign trade indicators allow to forecast an increasingly negative contribution from net exports. With this information, the Central Bank's technical staff believes that economic growth for the first quarter would be about 3.2%.

As for credit, in the first quarter, the banking loan portfolio in local and foreign currency addressed to companies maintained a low annual growth (3.1%). If direct external credit in foreign currency and bonds issued by companies in local currency were added to this portfolio, the commercial debt would have been more dynamic. The consumer loan portfolio continued to accelerate, while the mortgage credit growth has moderated. Both recorded annual increases close to 10%. Real interest policy rates as well as those for commercial credit, mortgage and consumption (except credit cards) stand at levels below the averages of the past ten years.

Compared to the previous Inflation Report, for all 2019, the technical staff at the Central Bank maintained the forecast for oil prices relatively stable; reduced the expected paths of economic growth of the country's trading partners and of the cost of external financing; increased slightly the forecast of economic growth for Colombia (from 3.4% to 3.5%); and reduced the expected path of inflation.

At the time of this Report, the announcements by the FED suggested greater downside risks to economic growth in the United States, compared to a quarter ago. The expectations of economic growth also moderated in the euro zone and in other advanced and emerging economies. These facts, together with the absence of inflationary pressures, led the national central banks of these countries to announce a pause in their process of normalization of monetary policy in 2019.

So far this year, the price of oil has increased, largely due to global supply restrictions. However, the futures market and the average by analysts see this trend as transitory. In this environment, for 2019, the technical staff at the Central Bank forecasts an average price of USD 63.4 per barrel (before: USD 63 per barrel).

The economic growth forecast of the technical staff for 2019 increased from 3.4% to 3.5%. According to the new projection, domestic demand would accelerate mainly due to a recovery of investment, caused in part by the positive effect of the Financing Act and by the greater dynamism of civil works (4G). The better conditions for external financing, the slowdown of trading partners, and the lower expected path of oil prices *vis-à-vis* 2018 would be reflected in a widening of the trade and the current account deficits. The output gap would close partially in 2019.

The inflation forecast fell slightly suggesting that in the remainder of the year and in 2020 inflation would remain within a range between 3.0 and 3.3%. The CPI for regulated items is expected to slow down, but supply constraints (mainly in energy) would maintain their growth above 5.0%. The food CPI would continue with rates of increase somewhat higher than the target. Inflation excluding food and regulated items (which stood at 2.38% in March 2019) would converge to 3.0% driven by the gradual closing of the output gap and by the annual nominal depreciation observed and expected and its transfer to domestic prices.

In all, the economy is still recovering from an output level lower than its long-term value. Inflation and inflation expectations stand somewhat above the target, and the average of core inflation indicators is slightly below 3.0%. The monetary policy stance is slightly expansionary. The external and internal factors of the economy suggest a gradual closing of the output gap, convergence of core inflation to the target, and a widening of the external deficit in 2019.

Based on this information, the Board of Directors (BDBR) in its meetings in March and April 2019 considered the following factors to reach a decision:

- Observed inflation will be close to the target and the upside risks are low.
- The spare capacity of the economy and the uncertainty about the pace of its reduction.
- The effects derived from external conditions on the Colombian economy remain uncertain.

In this environment, upon assessing the situation of the economy and the risk balance, the Board deemed appropriate to maintain the benchmark interest rate at 4.25%.

The Board of Directors will continue to carefully monitor the behavior of inflation and the forecasts of economic activity and inflation in the country, alongside the international situation. Finally, the Board reiterates that monetary policy will depend on the new information available.

Presentation of the Inflation Report for the 1st Quarter of 2019

Watch the presentation of the #InflationReport for the first quarter of 2019 on Monday, May 20, by the Governor of *Banco de la República*, #JuanJoséEchavarría.

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