Monetary Policy Report in the Current Context of Covid-19

Macroeconomic Summary

Recent data on economic activity, inflation and the job market suggest their trends have been in line with the technical staff's assessment of the state of the economy and how it is expected to evolve, characterized by a slump in demand and the persistence of ample surplus productive capacity. An anticipated sharp descent in output materialized during the second quarter. It helped to lower inflation below the 3% target and was mirrored in a severe drop in the labor market. A slow recovery in output and employment is still forecast for the remainder of this year and in 2022, but below the target.

In 2020, the Colombian economy would have experienced a sharp recession (7.6% drop in GDP), but less so than was forecast in the last report (8.5% decline in GDP). From the second half of the year going forward, output levels would recover slowly, without reaching pre-pandemic values in 2021 and in an environment of considerable uncertainty. The drop in output during the first half of the year was less than estimated, due to an upward revision of first-quarter GDP and a smaller contraction in the second quarter (-15.5%) than was forecast (-16.5%). Available indicators of economic activity suggest the annual decline in GDP during the third quarter would be around 9%. It is assumed there will be no important acceleration in Covid-19 contagion during the remainder of the year and in 2021, nor any further tightening of social distancing measures that would significantly affect economic activity. This being the case, the economy would continue to open gradually, and supply in the sectors most affected by the pandemic would slowly recover as the restrictions continue to be lifted. On the expenditure side, improved household confidence, pent-up demand for various goods and services, higher than expected external demand and low real interest rates would contribute to the recovery in output. Moreover, a low base of comparison would explain a large part of the increase in GDP during 2021. Given all this, economic growth in 2020 is expected to be between -9% and -6.5%, with -7.6% as the central value. For 2021, growth is forecast at 3% to 7%, with 4.6% as the central value (Graph 1.1). Compared to the July report, the upward revision in economic forecasts incorporates the smaller drop observed during the first half of the year and a somewhat faster than expected recovery in several economic sectors during the third quarter. The growth forecast ranges for 2020 and 2021 have narrowed but remain wide and reflect considerable uncertainty about how the pandemic will evolve, the possible measures needed to deal with it, and its impact on global and local economic activity.

Deterioration in the job market has been significant, with the unemployment rate (UR) remaining at historically high levels, despite some improvement in job numbers, especially in the urban informal sector. Even with month-on-month growth since May, employment in August was still 2.9 million jobs less than before the pandemic (February). The slow recovery in the demand for labor in cities has been concentrated in the non-salaried group, particularly among self-employed workers, and to a lesser extent in formal employment. Between May and August, three million people rejoined the labor supply, and a considerable proportion of them have transitioned back into employment, either to their old jobs or to new ones. However, the portion of inactive workers who could enter the market and bring upward pressure to bear on the UR in the coming months remains significant. The national UR is expected to decline during the fourth quarter of 2020 to somewhere between 15.1% and 16.9%. Therefore, the labor market would remain extremely loose and would help to explain the economy's considerable surplus productive capacity and the sharp deterioration in disposable household income.

The inflation forecast was revised upward but remained below 2% and 3% for the end of 2020 and 2021, respectively. Average inflation expectations for December are under 2% and are still below or close to the

target at five years and less. In September, annual inflation (1.97%) continued to decline, although less than was forecast in the July report (1.63%). Even so, downward pressures on inflation continue to be important and would help to keep it below target throughout the forecast horizon. The weather and the supply of perishable foods are expected to perform well, a situation that will keep on contributing to the slowdown in this CPI item. Surplus productive capacity would remain ample and be a factor in low price adjustments. Additionally, the annual variation in some groups that are persistently and heavily indexed to inflation (rents and educational services) continues to decline, and this trend is expected to endure in 2021. Yet, inflation would increase as of the second quarter of that year due to the fading effects of the price relief measures adopted in response to the pandemic. The projected path for inflation rose slightly compared to the previous forecast but remains below target. This increase is explained, in the first place, by the fact that the transitory reduction in the consumption tax applied to meals outside the home (CFH) has not been passed on to the end consumer and, for this reason, no reductions in this item are expected during the remainder of the year. Cost pressures (biosecurity, regulations on the use of installed capacity, etc.) associated with the “new normal” for dealing with the pandemic could be influencing these prices. Secondly, the output gap in 2021 is expected to remain extremely negative but likely will close somewhat faster than was projected in the last report. Finally, added pass-through of accumulated peso depreciation to some CPI groups is expected. All in all, by the end of 2020 and 2021, inflation would be around 1.9% and 2.6%, respectively. The different measures of inflation expectations for this same horizon are at similar levels. As in the case of economic activity, uncertainty about the inflation forecast is high, which is why ranges between 1.3% and 2.3% are projected for the end of 2020, and between 2.0% and 3.0% for 2021 (Graph 1.2).

External demand and oil prices would continue to recover slowly and would not reach pre-pandemic levels by 2021. There is a great deal of uncertainty about the speed and sustainability of this recovery. The data for the third quarter showed better momentum in global economic activity and workers' remittances, and higher oil prices compared to the significant drop in these variables posted during the second quarter of the year. This occurred in an environment marked by fewer restrictions on mobility, a gradual opening of several economic sectors, strong monetary and fiscal stimuli, and a reduction in the oil supply. Average output for the country's trading partners is expected to fall by around 7.7% during 2020, in a range between -9.5% and -6.0%, and to recover by around 4.6% in 2021, within a range of 2.0% to 7.0% (Chart 1.3). During those same years, the average price of oil is assumed to be US$ 42 and US$ 49 per barrel, respectively. The strong resurgence of Covid-19 in some countries, low levels of confidence, considerable government indebtedness, the high number of companies with financial problems, coupled with the economic and political tensions between the United States and China, are factors that generate extreme uncertainty about the recovery in external demand and commodity prices.

External and domestic financial conditions have improved in an environment of ample liquidity, although some indicators have yet to reach the levels witnessed at the beginning of the year. The major central banks have expanded their balance sheets considerably, as reflected by ample liquidity in the global economy. In the United States, the Federal Reserve recently announced changes to its monetary policy framework that could imply an expansionary stance for some time to come. Measures of global and country risk premiums have been reduced, but remain higher than prior to the pandemic, in an environment of considerable uncertainty about how they will evolve in the future, given the increase in public debt and the fact that some emerging countries have been downgraded. In Colombia, the decline in household portfolio levels came to a halt at the beginning of October, while those of the commercial portfolio dropped slightly, and both saw slowdowns in their annual growth rates. The transmission of policy rate reductions to interbank and deposit rates has been significant, while the transmission to commercial and consumer interest rates continues to be slower. Mortgage interest rates have remained relatively stable.

1.2 Monetary Policy Decision

At its August and September meetings, the BDBR decided to lower the monetary policy rate by a quarter of a percentage point in both instances. In October, it decided to hold the benchmark interest rate at 1.75% (Chart 1.4). The August and October decisions were taken unanimously and the September decision, by a majority vote.

Virtual press conference: Monetary Policy Report Presentation - November 4, 2020 from Banco de la República - Colombia on Vimeo.

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Publication Date:
Tuesday, November 3, 2020 - 12:00
Hour
18:32

- Print