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Keep in mind

The Monetary Policy Report presents the Bank's technical staff's analysis of the economy and the inflationary situation and its medium and long-term outlook. Based on it, it makes a recommendation to the Board of Directors on the monetary policy stance. This report is published on the second business day following the Board of Directors' meetings in January, April, July, and October.

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Starting in October 2019, the quarterly Inflation Report produced by the technical staff of the Central Bank will be known as the Monetary Policy Report. The document, which is used for the technical staff´s monetary policy recommendation, will be published on the working day after the meeting of the BDBR in January, April, July, and October, simultaneously with the Board minutes.

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1.1 Macroeconomic summary

Several factors contributed to an increase in projected inflation on the forecast horizon, keeping it above the target rate. These included inflation in December that surpassed expectations (5.62%), indexation to higher inflation rates for various baskets in the consumer price index (CPI), a significant real increase in the legal minimum wage, persistent external and domestic inflationary supply shocks, and heightened exchange rate pressures. The CPI for foods was affected by the persistence of external and domestic supply shocks and was the most significant contributor to unexpectedly high inflation in the fourth quarter. Price adjustments for fuels and certain utilities can explain the acceleration in inflation for regulated items, which was more significant than anticipated. Prices in the CPI for goods excluding food and regulated items also rose more than expected. This was partly due to a smaller effect on prices from the national government's VAT-free day than anticipated by the technical staff and more persistent external pressures, including via peso depreciation. By contrast, the CPI for services excluding food and regulated items accelerated less than expected, partly reflecting strong competition in the communications sector. This was the only major CPI basket for which prices increased below the target inflation rate. The technical staff revised its inflation forecast upward in response to certain external shocks (prices, costs, and depreciation) and domestic shocks (e.g., on meat products) that were stronger and more persistent than anticipated in the previous report. Observed inflation and a real increase in the legal minimum wage also exceeded expectations, which would boost inflation by affecting price indexation, labor costs, and inflation expectations. The technical staff now expects year-end headline inflation of 4.3% in 2022 and 3.4% in 2023; core inflation is projected to be 4.5% and 3.6%, respectively. These forecasts consider the lapse of certain price relief measures associated with the COVID-19 health emergency, which would contribute to temporarily keeping inflation above the target on the forecast horizon. It is important to note that these estimates continue to contain a significant degree of uncertainty, mainly related to the development of external and domestic supply shocks and their ultimate effects on prices. Other contributing factors include high price volatility and measurement uncertainty related to the extension of Colombia's health emergency and tax relief measures (such as the VAT-free days) associated with the Social Investment Law (*Ley de Inversión Social*). The as-yet uncertain magnitude of the effects of a recent real increase in the legal minimum wage (that was high by historical standards) and high observed and expected inflation, are additional factors weighing on the overall uncertainty of the estimates in this report. The size of excess productive capacity remaining in the economy and the degree to which it is closing are also uncertain, as the evolution of the pandemic continues to represent a significant forecast risk. margin, could be less dynamic than expected. And the normalization of monetary policy in the United States could come more quickly than projected in this report, which could negatively affect international financing costs. Finally, there remains a significant degree of uncertainty related to the duration of supply chocks and the degree to which macroeconomic and political conditions could negatively affect the recovery in investment.

The technical staff revised its GDP growth projection for 2022 from 4.7% to 4.3% (Graph 1.3). This revision accounts for the likelihood that a larger portion of the recent positive dynamic in private consumption would be transitory than previously expected. This estimate also contemplates less dynamic investment behavior than forecast in the previous report amid less favorable financial conditions and a highly uncertain investment environment. Third-quarter GDP growth (12.9%), which was similar to projections from the October report, and the fourth-quarter growth forecast (8.7%) reflect a positive consumption trend, which has been revised upward. This dynamic has been driven by both public and private spending. Investment growth, meanwhile, has been weaker than forecast. Available fourth-quarter data suggest that consumption spending for the period would have exceeded estimates from October, thanks to three consecutive months that included VAT-free days, a relatively low COVID-19 caseload, and mobility indicators similar to their pre-pandemic levels. By contrast, the most recently available figures on new housing developments and machinery and equipment imports suggest that investment, while continuing to rise, is growing at a slower rate than anticipated in the previous report. The trade deficit is expected to have widened, as imports would have grown at a high level and outpaced exports. Given the above, the technical staff now expects fourth-quarter economic growth of 8.7%, with overall growth for 2021 of 9.9%. Several factors should continue to contribute to output recovery in 2022, though some of these may be less significant than previously forecast. International financial conditions are expected to be less favorable, though external demand should continue to recover and terms of trade continue to increase amid higher projected oil prices. Lower unemployment rates and subsequent positive effects on household income, despite increased inflation, would also boost output recovery, as would progress in the national vaccination campaign. The technical staff expects that the conditions that have favored recent high levels of consumption would be, in large part, transitory. Consumption spending is expected to grow at a slower rate in 2022. Gross fixed capital formation (GFCF) would continue to recover, approaching its pre-pandemic level, though at a slower rate than anticipated in the previous report. This would be due to lower observed GFCF levels and the potential impact of political and fiscal uncertainty. Meanwhile, the policy interest rate would be less expansionary as the process of monetary policy normalization continues. Given the above, growth in 2022 is forecast to decelerate to 4.3% (previously 4.7%). In 2023, that figure (3.1%) is projected to converge to levels closer to the potential growth rate. In this case, excess productive capacity would be expected to tighten at a similar rate as projected in the previous report. The trade deficit would tighten more than previously projected on the forecast horizon, due to expectations of an improved export dynamic and moderation in imports. The growth forecast for 2022 considers a low basis of comparison from the first half of 2021. However, there remain significant downside risks to this forecast. The current projection does not, for example, account for any additional effects on economic activity resulting from further waves of COVID-19. High private consumption levels, which have already surpassed pre-pandemic levels by a large margin, could be less dynamic than expected. And the normalization of monetary policy in the United States could come more quickly than projected in this report, which could negatively affect international financing costs. Finally, there remains a significant degree of uncertainty related to the duration of supply chocks and the degree to which macroeconomic and political conditions could negatively affect the recovery in investment.

External demand for Colombian goods and services should continue to recover amid significant global inflation pressures, high oil prices, and less favorable international financial conditions than those estimated in October. Economic activity among Colombia's major trade partners recovered in 2021 amid countries reopening and ample international liquidity. However, that growth has been somewhat restricted by global supply chain disruptions and new outbreaks of COVID-19. The technical staff has revised its growth forecast for Colombia's main trade partners from 6.3% to 6.9% for 2021, and from 3.4% to 3.3% for 2022; trade partner economies are expected to grow 2.6% in 2023. Colombia's annual terms of trade increased in 2021, largely on higher oil, coffee, and coal prices. This improvement came despite increased prices for goods and services imports. The expected oil price trajectory has been revised upward, partly to supply restrictions and lagging investment in the sector that would offset reduced growth forecasts in some major economies. Elevated freight and raw materials costs and supply chain disruptions continue to affect global goods production, and have led to increases in global prices. Coupled with the recovery in global demand, this has put upward pressure on external inflation. Several emerging market economies have continued to normalize monetary policy in this context. Meanwhile, in the United States, the Federal Reserve has anticipated an end to its asset buying program. U.S. inflation in December (7.0%) was again surprisingly high and market average inflation forecasts for 2022 have increased. The Fed is expected to increase its policy rate during the first quarter of 2022, with quarterly increases anticipated over the rest of the year. For its part, Colombia's sovereign risk premium has increased and is forecast to remain on a higher path, to levels above the 15-year-average, on the forecast horizon. This would be partly due to the effects of a less expansionary monetary policy in the United States and the accumulation of macroeconomic imbalances in Colombia. Given the above, international financial conditions are projected to be less favorable than anticipated in the October report. The increase in Colombia's external financing costs could be more significant if upward pressures on inflation in the United States persist and monetary policy is normalized more quickly than contemplated in this report. As detailed in Section 2.3, uncertainty surrounding international financial conditions continues to be unusually high. Along with other considerations, recent concerns over the potential effects of new COVID-19 variants, the persistence of global supply chain disruptions, energy crises in certain countries, growing geopolitical tensions, and a more significant deceleration in

China are all factors underlying this uncertainty.

The changing macroeconomic environment toward greater inflation and unanchoring risks on inflation expectations imply a reduction in the space available for monetary policy stimulus. Recovery in domestic demand and a reduction in excess productive capacity have come in line with the technical staff's expectations from the October report. Some upside risks to inflation have materialized, while medium-term inflation expectations have increased and are above the 3% target. Monetary policy remains expansionary. Significant global inflationary pressures and the unexpected increase in the CPI in December point to more persistent effects from recent supply shocks. Core inflation is trending upward, but remains below the 3% target. Headline and core inflation projections have increased on the forecast horizon and are above the target rate through the end of 2023. Meanwhile, the expected dynamism of domestic demand would be in line with low levels of excess productive capacity. An accumulation of macroeconomic imbalances in Colombia and the increased likelihood of a faster normalization of monetary policy in the United States would put upward pressure on sovereign risk perceptions in a more persistent manner, with implications for the exchange rate and the natural rate of interest. Persistent disruptions to international supply chains, a high real increase in the legal minimum wage, and the indexation of various baskets in the CPI to higher inflation rates could affect price expectations and push inflation above the target more persistently. These factors suggest that the space to maintain monetary stimulus has continued to diminish, though monetary policy remains expansionary.

1.2 Monetary policy decision

Banco de la República's board of directors (BDBR) in its meetings in December 2021 and January 2022 voted to continue normalizing monetary policy. The BDBR voted by a majority in these two meetings to increase the benchmark interest rate by 50 and 100 basis points, respectively, bringing the policy rate to 4.0%.