

INFLATION DEVELOPMENTS AND MONETARY POLICY DECISIONS

In March 2017, annual consumer inflation fell for the eleventh consecutive month, standing at 3.99% (Graph A). The behavior of foods, and to a lesser extent, that of tradables excluding food and regulated items, explained most of the fall in inflation in the second quarter of the year. This suggests that the supply shocks continue fading (*El Niño* and nominal depreciation of the peso, mainly), which deviated inflation from its target, and it is likely that its accumulated effects will disappear in the second half of the year.

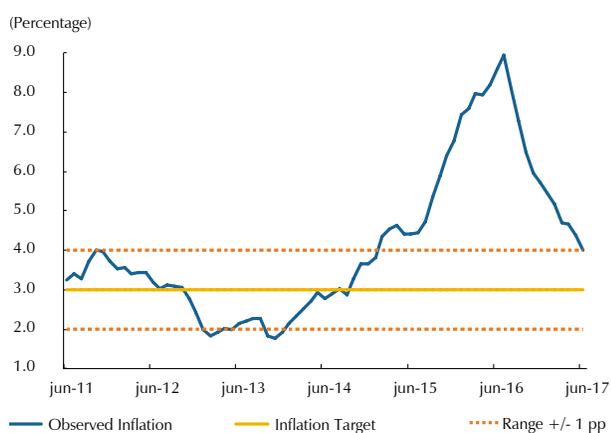
On the other hand, the four core inflation indicators (which do not incorporate the prices that respond to supply shocks, or those which are highly volatile) fell at a slower pace. To June, the average of these indicators stood at 5.09%, a figure lower than in the first quarter, but still well above the 3.0% target.

As described in the previous Inflation Report, several factors explain the lower descent of core inflation *vis-à-vis* total inflation. One of them is the increase in the value added tax (VAT) and other indirect taxes, whose largest impact has been on the tradable CPI excluding food and regulated items. Another one is the indexation of prices and wages, which has increased the persistence of inflation and has delayed the deceleration of the CPI, especially in non-tradable goods and services, such as leases.

Inflation expectations continue to converge to the target. Those by economic analysts to December 2018 are at 3.5%, similar to the inflation expectations embedded in public debt bonds to longer terms, which are between 3.3% and 3.6%.

Regarding economic growth, the Colombian economy is culminating the adjustment process, as a response to the deterioration of national income since mid-2014. The fall in the terms of trade, the behavior of the neighboring countries, and the recent

Graph A
Headline Consumer Inflation



Sources: DANE and Banco de la República.

tax reform, which was necessary to recover public revenues and to ensure the country's fiscal and external sustainability, have affected household spending, and thus consumption. The lower purchasing power of households due to the increase in inflation and monetary policy actions required to return inflation to its 3.0% target have also explained the economic dynamics. Although external demand has recovered slightly, its expansion has been slow and has been insufficient to promote robust exports by the country.

Indicators of economic activity in the second quarter suggest that domestic demand remains weak. In fact, the consumer confidence index and retail sales suggest that consumption is growing at historically low rates. Investment could register a modest recovery, mainly due to civil works; net exports would have subtracted from growth. With these figures, the technical staff at *Banco de la República* estimates an economic growth figure of 1.2%¹ for the second quarter of 2017, within a range between 0.7% and 1.7%.

For the remainder of 2017, a low increase in output is expected, exhibiting a modest recovery in the second half of the year. The behavior of domestic demand would continue to be weak, led by investment in civil works. External demand and the country's terms of trade are likely to continue recovering within a more dynamic environment (although highly uncertain) for world trade. With all this in mind, the technical staff revised its forecast of the most likely growth figure for 2017 from 1.8% to 1.6%, within a range between 1.0% and 2.0%.

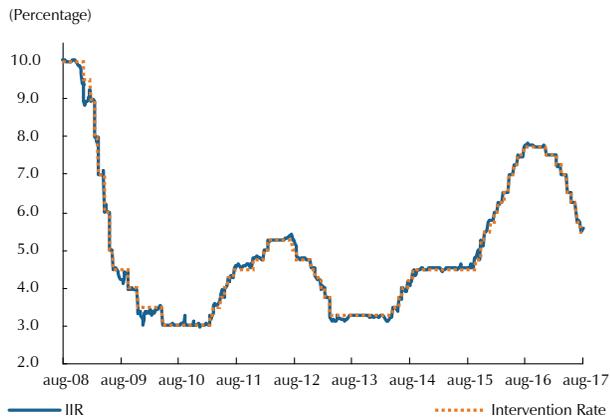
In all, the Colombian economy continues to adjust to the strong shocks recorded since 2014, and it is likely that the current account deficit will continue correcting. Output dynamics has been weaker than forecast; also, there is greater risk that the economic slowdown may be stronger than what is compatible with the deterioration in national income. The supply shocks that deviated inflation away from its target are still fading, which explains most of the deceleration of the CPI. The reversal of core inflation has been slower than that of headline inflation, as the former has been affected by the increases in taxes, indexation mechanisms, and by the increase of the persistence of inflation.

Facing this macroeconomic situation, the Board of Directors of the Central Bank considered the following issues in its most recent decisions:

- The increasing weakness in economic activity and the risk of a slowdown beyond what is compatible with the deterioration in the dynamics of income due to the fall in oil prices. Recent indicators confirm an excess capacity of the economy, although its magnitude is highly uncertain.

¹ The forecast for the second quarter and for all of 2017 was carried out with data available as of 27 July.

Graph B
 Banco de la República's Benchmark Interest Rate and
 Interbank Interest Rate
 (2009-2017)^{a/}



a/ The figures correspond to data from working days; the last figure corresponds to 11 August 2017.
 Sources: Superintendencia Financiera de Colombia and Banco de la República.

- Uncertainty about the pace of convergence of inflation to its 3.0% target. Indexation mechanisms and the persistence of inflation continue to be reflected on core inflation indicators, which exceed the inflation target (3.0%).
- The current level of the real policy interest rate *ex-ante* is contractionary. This rate is measured taking into account inflation expectations, which have been reducing.

Having analyzed the above, between May and July this year, the Board of Directors decided to reduce the benchmark interest rate by 100 bp (in May, -25 bp; in June and July, -50 and -25 bp) (Graph B). Additional reductions would consider the risk balance between a slow convergence of inflation to 3.0% and a greater slowdown of economic activity versus the forecast.

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