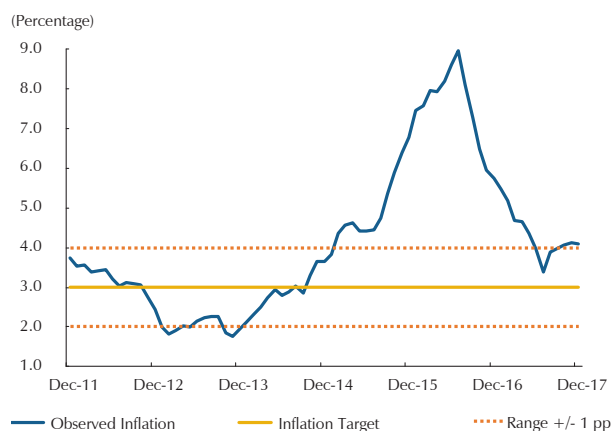


INFLATION DEVELOPMENTS AND MONETARY POLICY DECISIONS

Graph A
Headline Consumer Inflation



Sources: DANE and Banco de la República.

During the last two months of 2017, inflation increased somewhat more than expected, closing the year at 4.09% (Graph A). This behavior is explained by the acceleration of the consumer price index (CPI) excluding food, whose annual variation to December stood at 5.01%. Within this last group, all large groups (tradables, non-tradables, and regulated items) recorded higher rates of increase, ending the year at annual rates exceeding the 3.0% target.

As did the CPI excluding food, the other measures of core inflation also accelerated in the last two months of 2017. To October, these measures had exhibited a downward trend, although they remained above the target as a result of the indexation of

prices, the persistence of inflation, and the transitory effect of the new indirect taxes from early last year. The average of core inflation indicators drifted more from the target, standing at 4.66%.

The forecast of the Central Bank's technical staff suggests that annual inflation will decline significantly, although to a rate somewhat higher than projected in the *last Inflation Report*. According to the new forecast, in the first quarter of 2018, inflation will stand close to 3.6% instead of the 3.4% figure projected in October. This increase is explained mainly by the price of oil, which has increased so far more than the appreciation of the peso. Should this situation continue, the CPI for regulated items would be pushed upwards. It is also explained by a minimum wage increase well above the inflation target, which would exercise labor cost pressures, particularly in the production of certain goods and services intensive in labor with this type of remuneration (e.g., meals outside the home, building management services, household cleaning services, etc.).

Regarding inflation expectations for 2018 and 2019, the survey to analysts and those embedded in public debt bonds exhibited slight increases and range between 3.2% and 3.6%. The quarterly survey applied to companies, unions, and academics suggests that inflation to December this year and the next could reach 3.8%.

The previous behavior of inflation and inflation expectations was recorded along with a weak dynamics of the economy and a negative output gap. The forecast for GDP growth for all 2017 (1.6%) did not change, remaining below

the figure for potential growth of the economy. According to these projections, by the end of 2017, domestic demand would have slowed down, and its growth would have been less than output growth. In the same period, external demand would have driven growth due to the favorable behavior of exports.

The figures for the balance of payments also reflect an economy that is adjusting in an orderly manner. In the past quarter, exports in US dollars accelerated due to the increase of external sales of oil, coal, and non-traditional products. The annual increase in imports would have been negative, partly because of a high basis for comparison and by a weak domestic demand. Higher revenues generated by the significant growth in workers' remittances would be added to the lower trade deficit. With this, the technical staff reduced its estimate of the current account deficit for 2017 from 3.7% to 3.5% of GDP, and projected that it would continue falling to 3.3% of GDP in 2018.

As for the credit market, the figures for December reflected a portfolio in real terms that is recovering slowly, with a behavior determined largely by commercial credit (including foreign currency, direct external credit, and bonds). The households' loans portfolio is still slowing down, but it still records high real rates of increase. These behaviors take place from historically high levels of debt relative to output, both for households as for enterprises.

The reductions in the benchmark interest rate would be contributing to the recovery of credit. These reductions have been transmitted to the interest rates on loans, mainly to the commercial and mortgage rates, and to a lesser extent, to consumption rates. To December, in real terms, the policy interest rate stood below its average calculated since 2000, as well as the real rates on ordinary, mortgage, and consumer loans (except credit cards).

Regarding the labor market, in the moving quarter to November, the unemployment rate for the 13 metropolitan areas increased and continued with a growing trend, a behavior that has been taking place for over a year. Despite this deterioration in the unemployment figures, the indicators of wages in various sectors of the economy were adjusted to rates higher than the inflation target, which is explained, to a large extent, by its indexation to the high inflation figure for 2016 (5.75%). It is likely—and desirable—that wage negotiations for 2018 (other than the minimum wage) will take into account the sharp decline registered in the past inflation figure and the one expected in the near future, much closer to our long-term 3.0% target. Additionally, estimates of the Central Bank's technical staff indicate slack in the labor market, which will contribute to reduce labor cost pressures on prices.

With all of the above, the technical staff maintained the growth forecast at 2.7% for 2018. In addition to the higher external demand expected and the recovery projected in the terms of trade, other reasons suggest that the output for this year will be higher than in 2017. Firstly, the reductions in policy interest rates carried out so far and a lower inflation should bring about a greater

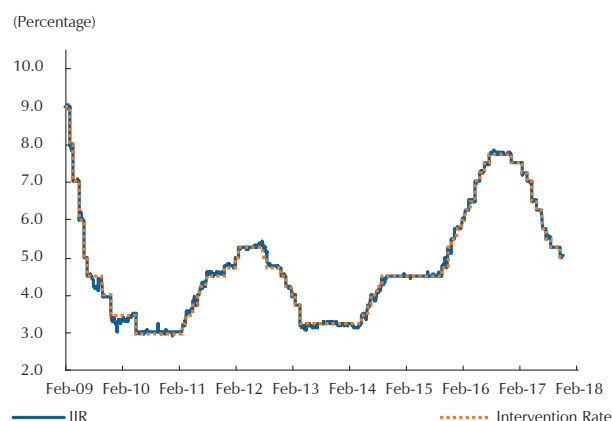
dynamics for household credit, investment, and expenditure. Additionally, investment in 2018 would be driven by a larger implementation of civil works (particularly 4G), and it is likely that, should the price of oil continue at high levels, foreign direct investment in this sector continues recovering. In any case, the GDP dynamics would be lower than its potential (3.3%), with which the excesses of installed capacity of the economy would widen once more.

As for the expected behavior of consumer prices in 2018, several factors should contribute to the convergence of inflation to its 3.0% target. Firstly, if the food supply remains at good levels, the prices of this group could continue adjusting with increases below the target. In addition, the direct effect of value added tax (VAT) on headline inflation should have faded completely in the second quarter. Also, the most sticky prices, as well as wages different from the minimum wage, are expected to be indexed to a lower inflation than in previous years. Similarly, a more negative output gap and a more slack labor market should contribute to the deceleration of inflation.

In all, in the last quarter of 2017, headline inflation and core inflation remained above the target. The forecasts for inflation and inflation expectations suggest that inflation will decline significantly in 2018, albeit at a level that would still exceed 3.0%. In the same sense, the labor market is slack and will possibly contribute to reduce labor cost pressures on prices. The economic growth forecast for 2017 and 2018 remained unchanged, suggesting that the negative output gap will continue to widen this year.

Within this macroeconomic scenario, during the past three months, the Board of Directors of the Central Bank assessed the risk balance, considering the high levels of excess capacity along with an expected recovery of the economy, and the pace of convergence of inflation to its target. With this assessment, in November 2018 and January 2019, the Board decided to reduce the benchmark interest rate by 25 bp, placing it at 4.5%. With the information available, the Board considers that the reduction cycle of the benchmark interest rate has been completed (Graph B).

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 8 February 2017.
Sources: Office of the Financial Superintendent of Colombia and Banco de la República.

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