Introduction

The main purposes of the first *Report* that the Board of Directors of *Banco de la República* (BDBR) submits to Congress at the beginning of its regular meetings each year are: to examine the performance of the country's economy during the immediately preceding year; to explain the actions for monetary policy and its contribution to the implementation of the inflation target; to report on the administrative management of the Central Bank and the management of the country's foreign reserves; and to discuss the economic outlook for the current year. While undergoing the preparation of this *Report* according to these guidelines, the pandemic of coronavirus arose and the collapse in oil prices took place. The strong reaction of capital and exchange markets reflect the stress and the bewilderment of economic agents in the face of this situation. The BDBR is aware that due to the timing of this *report* it will not be possible to provide all the answers that the Congress and the country are expecting. Market volatility and uncertainty about the future evolution of the pandemic and of oil prices demand caution when analyzing the new economic outlook resulting from this unexpected event.

At the time of writing this *Report*, the Board of Directors had taken measures to ensure the liquidity of the economy in both pesos and US dollars. Regarding liquidity in pesos, the total allotment for liquidity operations (repos) with public and private debt instruments was increased up to COP 23.5 trillion (t); the group of institutions with access to the auctions and the liquidity window of the Central Bank was expanded; the use of private debt instruments eligible to be used in repo operations was allowed; the maturities for liquidity operations were extended from thirty to ninety days with private debt instruments, and from one to sixty days for liquidity operations with public debt instruments. Also, the permanent injection of liquidity into the economy was authorized through the purchase of public debt instruments and securities issued by credit institutions to a wide group of financial agents. As for liquidity in US dollars, a new mechanism of intervention in the foreign exchange market to sell dollars through non-delivery forwards (NDF) was announced, originally offering USD 1,000 million (m). Additionally, it decided to carry out FX swaps auctions in dollars for USD 400 m, in which *Banco de la República* sells US dollars in cash and purchases them as futures (at 60 days). These measures facilitate the flow of enough credit resources and the proper operation of the payments system, also helping to alleviate the pressures in the foreign exchange market.

Banco de la República has deployed all available resources to tackle this emergency. The analysis tools developed by the Central Bank, along with the experience of the technical staff, will continue to be of great assistance to develop a complete diagnosis of the situation that will serve as a basis to take further policy measures as may be required. The results of these analyses will be announced in the upcoming *Monetary Policy Reports* and will be collected in the July edition of the *Report of the Board of Directors to the Congress of Colombia*.

Complying with its initial objectives, this *Report* analyzes the performance of the Colombian economy during the past year. In 2019, the country's economy grew 3.3%, consolidating the recovery started in 2018, when it grew 2.5% after the adjustment of the economic activity to the fall in oil prices in late 2014, which resulted in a slowdown in the country's economic growth rate to just 1.4% in 2017. This recovery took place thanks to domestic factors and contrasted the slowdown in the region. GDP growth in 2019 was higher than that of our peers in the region, and widely surpassed the average from Latin America and the Caribbean, which mainly remained stagnant, growing only 0.1% in 2019, as reported by the International Monetary Fund (IMF).

The growth of the Colombian economy during the previous year occurred within a context of a weakening of the external demand and lower terms of trade, which shows that domestically originated factors played in favor of maintaining economic dynamism. Among the latter, the strengthening of private consumption and private investment stands out, both of which expanded to rates over 4.0%, surpassing the records for 2018 and prior years. The good performance of the aforementioned items was reflected in the dynamics of domestic demand, which grew at a 4.5% rate. Weak external demand led to a growth of real exports that was far below that of imports (3.1% vs. 9.2%), which widened the country's trade imbalance.

The expansion of economic activity in 2019 coincided with an increase of headline consumer inflation from 3.18% in 2018 to 3.8% in 2019. However, this acceleration of inflation was not due to demand pressure, as the economy continued to operate below its potential despite its larger GDP growth. The upward pressure came, to a large extent, from transitory factors such as deterioration in food supply or modifications in the *ad valorem* tax to liquor. The increases in food prices were concentrated in the group of perishable items, originated by *El Niño* and other weather phenomena that affected several regions of the country. At the end of 2019, these shocks began to fade as the supply returned to normal. On the other hand, the pass-through of peso depreciation, which averaged 11% in 2019, pressed upwards the prices of processed foods. Similarly, it affected the basket of tradable goods (excluding food and regulated items), whose annual variation accelerated to 2.2% by the end of 2019 compared to 1.0% by the end of 2018. As for regulated goods and services, although the annual variation in this group remained relatively high, its adjustment pace decreased, mainly due to the performance of fuel prices.

Given the transitory nature of price increases and the existence of spare capacity, the Board decided to maintain the policy rate constant at 4.25% throughout the year. On the one hand, the spare capacity continued to exercise a moderating effect on inflation; on the other hand, transitory increases in prices due to deterioration in supply must not be confronted with increases in interest rates, unless these result in a significant increase in inflation expectations that may threaten to feedback on inflation in subsequent periods. Yet, this did not happen. The increase in inflation expectations was moderate, as monitored monthly by the technical staff through the expectations survey carried out by *Banco de la República*, in addition to other sources of information. This was possible since the economic agents foresaw the transitory nature of the price shocks and continued to trust the inflation target. Inflation results for January and February (3.62% and 3.72%, respectively), both less than the figure for inflation recorded in 2019 (3.8%), are consistent with the expectations of economic agents that the figure for inflation will approach the 3.0% target by the end of 2020.

Banco de la República's policy rate plays a key role in determining the rates for savings and credit in the economy. Since 30 April 2018, it has remained unchanged at a nominal 4.25%. By subtracting from that nominal interest rate the average value of inflation expectations to twelve months recorded since April 2018 (3.36%), an (*ex ante*) real interest policy rate of 0.89% is obtained. The monetary policy stance is determined by comparing this real policy rate with the neutral real interest rate. Estimates for the last 22 months suggest that the neutral real rate has fluctuated between 1.4% and 1.25%. The real policy rate of 0.89% has remained under that range all the time. Consequently, it can be stated that the monetary policy stance has been moderately expansionary during that period.

The BDBR began to reduce the policy interest rate starting in December 2016 from a 7.75% peak, and continued to do so until 30 April 2018, when it reached a level of 4.25%. It has remained unchanged since then. This reduction was transmitted to market interest rates with different lags. The first to react was the interest rate for commercial credit, which exhibited sharp falls in its different modalities during 2017 and 2018. The benchmark interest rate for consumer credit took longer to respond. Its decline concentrated in 2019, when it moved from 19.01% at the end of 2018 to 15.15% by the end of 2019. This context of low interest rates stimulated the demand for credit, especially that for consumption, whose portfolio closed last year with an annual 15.8% variation (real: 11.6%), which contributed to boost domestic demand via increased household consumption. The portfolio aimed at enterprises (commercial + microcredit) increased 4.2% in nominal terms (real: 0.4%) at the end of December 2019. The slow recovery of this type of credit, albeit low interest rates, shows that the demand for financing by firms continues to be weak.

The following is a summary of the main issues addressed in the *Report* with the purpose of providing an overview before delving into each one of them in subsequent chapters.

External Context

During 2019, global economic activity was affected by trade tensions and the imposition of tariffs between the United States and China, the risks of a disorderly *brexit*, and social protests in several countries. Trade volumes decreased, business and consumer confidence weakened, volatility of the financial markets increased, and global economic activity slowed down. While global growth reached 3.2% in 2017 and 3.0% in 2018, the figure for 2019 would have been 2.4%, according to estimates by the IMF and The World Bank (WB). Among advanced economies, in 2019 the Euro zone grew 1.2% and the United States 2.3%, which meant a reduction of 80 bp and 60 bp *vis-à-vis* 2018, respectively. Regarding emerging economies, China recorded a GDP variation of 6.1% in 2019, below the figure observed in 2018 (6.4%). Latin America and the Caribbean exhibited a substantial slowdown, reducing their growth from 1.0% in 2018 to 0.1% in 2019, according to the Economic Commission for Latin America and the Caribbean (ECLAC).

Faced with a scenario of low growth and absence of inflationary pressures, some central banks from advanced economies and emerging markets continued with a process of monetary relaxation. The Fed lowered its policy rate on three occasions, reducing the range from 2.25% - 2.50% to 1.50% - 1.75%, while the European Central Bank (ECB) cut the interest rates to historical lows and resumed its asset-purchase program in November in amount of EUR 20,000 million a month. The central banks of Japan and England maintained their rates stable, but continued with their asset-purchase programs. As for emerging economies, the People's Bank of China lowered its interest rates three times, cutting them by 20 bp in total; on the other hand, Brazil, Mexico, Peru, and Chile reduced their rates in order to provide a greater monetary stimulus.

The weakening of external demand pressed downwards the prices of raw materials, while geopolitical and idiosyncratic situations led to greater volatility. As for oil, the implicit prices per barrel for Colombian crude decreased from an average of USD 62.9 in 2018 to USD 58.4 in 2019 as a result of the fall in the international prices of Brent oil, which is used as a reference in Colombia. Similarly, international prices of coal declined from an average of USD 85.9 per ton in 2018 to USD 75.8 in 2019. As a result, the country's terms of trade suffered a deterioration that contributed to widen the trade imbalance in 2019, as will be explained later in this *Report*.

For 2020, the initial forecasts by international agencies suggested a slight upturn in global growth, sustained in the recovery of some emerging economies that experienced adversities in 2019 and in a lower risk perception following the signature of the first phase of the trade agreement between the United States and China. However, global circumstances have changed dramatically. The great concern is the health of humanity. The pandemic of the new coronavirus could bring a decline in global economic activity of a still unpredictable but significant magnitude. Added to this is the sharp fall in the prices of international oil prices, which are already close to being the minimum of the last decade due to the contraction of the demand for crude oil and to the excessive supply generated by the recent failure of negotiations by the OPEC and its allies. In this environment, the stock exchanges have recorded great losses. Value chains, most of which involve parts manufactured in China, have begun to be interrupted, and the movement of people has declined. On the economic front, the greatest concerns are the prospects of a global recession and its negative effects on employment. Some central banks, such as the Federal Reserve of the United States as well as those in Canada, Australia, and England have reacted with strong cuts to their interest rates and with provision of liquidity to the economy. The central banks from the region have started to act similarly, as is the case with Chile, Mexico and Peru, among others. As mentioned, at the time of writing this *Report*, the Board of Directors had taken extraordinary measures to ensure the liquidity of the Colombian economy in both pesos and US dollars.

Economic Activity

As already noted, the 3.3% expansion of GDP in 2019 originated in the strengthening of domestic demand. Regarding total consumption, the main contribution came from households, whose aggregate consumption grew to 4.6%, compared to 3.0% in 2018. Consumption of durable and semi-durable items stands out for its dynamism, with growth figures of 6.7% and 5.7%, respectively. The reduction of the interest rate for consumption loans may have influenced this result. The increases in consumption of non-durable items (4.6%) and services (3.9%) were also relatively high, especially when compared with their low records in 2018 (2.0% and 2.6%, respectively). This suggests that other factors played in favor. It is worth noting here the strong increase of external remittances by workers that increased the available income of households, and immigration, which has increased consumption of goods and services in the country. Finally, public consumption increased 4.3% along the year, which, despite being lower than the figure recorded in 2018 (7.0%), may still be seen as a positive outcome, considering the Central Government's limitations in expenditure necessary to comply with the fiscal rule.

Gross capital formation grew 4.3% in 2019, twice the pace observed in 2018 (2.1%), which boosted economic activity. The most dynamic item was that of investment in machinery and equipment, thanks to the stimulus by the Financial Act of 2018 (*Ley de financiamiento)* and the renewal of public transport fleets in different cities. Investment in construction exhibited a heterogeneous behavior. On the one hand, there was a contraction in housing investment due to the significant excessive supply that has not yet adjusted via prices. On the other hand, investment in other buildings and structures exhibited a significant recovery after the fall observed in 2018, thanks largely to increased investment in civil works.

From the standpoint of the productive sectors, the greatest contribution to economic growth came from branches of economic activity that can be characterized as services such as trade, repair, transportation, and accommodation; together with public administration and defense, education and health, and financial and insurance activities, whose annual growth rates revolved around 5.0%. Contrastingly, primary activities such as agriculture and mining exhibited low growth (2.0% or less). Even so, it should be noted that mining grew again in 2019 (2.1%) after five consecutive years of contraction after the oil shock in 2014.

Inflation

Annual consumer inflation in 2019 closed at 3.80%, surpassing the figure of a year before (3.18%). The increase in inflation was explained to a large extent by transitory supply shocks due to unfavorable weather conditions that pressed food prices upwards. The annual increase in this item (5.66%) was the largest contributor to headline inflation in 2019. Also, the pass-through of depreciation of the peso to the prices of tradable goods contributed to this. The dynamics of domestic demand had little impact on prices largely due to the persistence of spare capacity and a slack labor market. Credibility in the monetary policy stance also contributed to this, maintaining inflation expectations close to 3.0%.

On the other hand, core inflation, which provides useful information for monetary policy by reflecting the state of aggregate demand better, recorded lower increases than headline inflation and from levels that were lower than the target. Particularly, inflation excluding food and regulated items, which had stood at the end of 2018 at 2.6%, gradually converged to the target throughout the year, closing 2019 at 3.1%. The other core inflation indicators monitored by the Central Bank followed a similar trend, albeit with higher values, with which the average of the four indicators was 3.3% at the end of 2019.

Employment

Although in 2019 the pace of economic activity continued to recover vis-à-vis 2018, the unemployment rate (UR) maintained a growing trend both for the national total as for all other geographical domains. The increase in the unemployment rate was partially mitigated by a widespread reduction in labor supply. Among the factors that could have influenced this behavior are the increase in remittances from abroad and the downward pressure that migration from Venezuela could have exerted on labor income of less skilled and informal workers, discouraging them from participating. Thus, the impact of migration on the UR would have been low, and this new population would be being absorbed mainly by the informal market.

The national UR stood at 10.5% in December 2019, a level higher than observed both in the second quarter of the year (10.3%) as in December 2018 (10.1%). In general, this has been the result of a labor demand (as measured by the occupation rate, OR) that has been contracting faster than the labor supply (measured by the global participation rate, GPR)[1]. Thus, for example, the OR exhibited an annual contraction of 0.8 percentage points (pp) in the moving quarter of October-December and remained relatively stable *vis-à-vis* the first half of 2019. The annual declines in this indicator are explained by higher growth in the working-age population *vis-à-vis* the figure for occupied individuals. The annual deterioration of the OR is due to the contraction in employment of the other municipalities and rural areas, where there is evidence of a weak agricultural labor demand. In turn, during the same period, the national GPR continued its downward trend, falling 0.6 pp with respect to the records from a year before. The largest reductions in the labor supply have

1 These relationships are better understood with the following formulas:

$UR = 1 - [occupation\ rate\ (OR) / participation\ rate\ (GPR)]$

$OR = occupied / working\text{-}age\ population\ (WAP)$

$GPR = economically\ active\ population / working\text{-}age\ population\ (WAP)$

taken place in rural areas, mainly in secondary household workers (not chiefs) and young people with no higher education, who during this period became inactive. By economic branches of economic activity, agriculture, which accounts for about 16% of the total number of employed individuals in the country, exhibited the worst performance regarding employment generation. Particularly, it is evident that in the agricultural sector crops from non-specialized units showed the biggest fall in the number of occupied individuals during 2019. The sectors of trade, construction, and services are leading job creation in the national total. The last two positively contributed the most to the increase of occupied individuals in the thirteen major urban areas, while the branches related to services to enterprises such as real estate, renting and business, recorded less job generation in this domain.

External Balance

The current account deficit of the balance of payments in 2019 amounted to USD 13,800 m, greater by USD 753 m to the records in 2018. As a share of GDP, it rose from 3.9% in 2018 to 4.3% in 2019. Several factors explain this increase. Firstly, the dynamics of domestic demand (driven by a higher household expenditure) and gross capital formation thrust the imports of goods, which reached the amount of USD 50,821 m, with an annual 2.5% increase (USD 1,237 m) along the year. Secondly, the lower export prices and the slowdown of the country's main trading partners were reflected in a 4.6% fall of exports of goods, reaching USD 42,374 m, lower by USD 2,066 m than the amount exported in 2018. As a result, the trade deficit in 2019 totaled USD 8,447, with a USD 3,303 m increase (64.2%). In contrast, the remaining items of the current account contributed to moderate the imbalance originated in the trade of goods. Thus, the deficit in primary income lowered USD 1,455 m; that of the balance of services USD 62 m; and the surplus of current transfers increased by USD 1,033 m.

As detailed in the *Report*, the decline in exports originated mainly in lower sales of coal, oil, and industrial products abroad. In the case of coal, the fall in external sales was due to the combined effect of lower volume exported (14%) and falling prices (11.7%). Something similar happened with exports of crude oil, whose selling prices were lower by 7.2%, although on this occasion the fall in prices was partially offset by the increase in the quantities sold (1.3%). Regarding imports, their increase is explained mainly by the increase of foreign purchases of fuels and lubricants (28.3%), transportation equipment (13.4%), and consumer goods (5.3%). As for the reduction of the deficit in factor income, this was mainly due to the decrease of the profits obtained by companies with foreign direct investment (FDI), particularly those dedicated to mining, quarrying, and oil exploitation. Regarding current transfers, a net income of USD 8,676 m was received during 2019, i.e., 13.5% more than in 2018. This result is explained particularly by the largest amount of workers' remittances, which amounted to USD 6,744 m in 2019, with an annual 6.7% increase (USD 422 m). The main increases in income from remittances came from the United States, Spain, Canada, and Australia.

The current account deficit in 2019 increased the external financing needs, which, according to the financial account of the balance of payments, came from net capital inflows for USD 13,102 m (4.1% of GDP), higher by USD 687 m to a year ago, when it amounted to USD 12,415 m (3.7% of GDP). FDI continued to be the main source of external resources reaching a value of USD 14,493 m (4.5% of GDP), higher by USD 2,958 m (25.6%) to the amount received a year before. Close to one-third of these resources from FDI were directed toward the mining-energy sector in order to sustain or increase production levels. Other areas that received significant amounts from FDI were financial and business services, trade and hotels, and manufacturing industry. Additionally, access to other sources of external financing continued (USD 5,156 m), such as indebtedness and portfolio flows, within a context where both international interest rates and risk premia remained relatively low.

Foreign Reserves

Net international reserves as of December 2019 totaled USD 53,167.2 m, amount higher by USD 4,774.3 m to the balance recorded in December 2018. This increase resulted from the purchase of foreign currency and the profitability of the country's international reserves. The Board of Directors decided to increase the amount of international reserves at its session in September 2018, considering the temporary nature of the Flexible Credit Line (FCL) with the IMF. The accumulation mechanism was put option auctions. This program extended until 31 May 2019, when the Board decided to suspend it in order to assess its incidence on the behavior of the foreign exchange market. Through that program, USD 1,878 m were accumulated (of which USD 1,478.1 m were in 2019). Seeking to strengthen the accumulation of reserves and considering that the National Government planned to perform some monetization operations in US dollars in its financial programming of 2019, *Banco de la República* bought USD 1,000 million from the National Treasury on 1 February 2019 at the representative market rate in force on that day.

During 2019, USD 2,322.76 m were received from the profitability of the reserves, an amount higher than in the past few years. This increase is explained by the increase in the prices of portfolio bonds facing the fall in the interest rates (valorization factor), while interest accrual remained at relatively high levels compared to the average in the decade (interest factor).

The amount of net international reserves is complemented with a line of contingent financing with the IMF which was renewed on 25 May 2018 and was reaffirmed by the IMF on 20 May 2019, for USD 7,848 million special drawing rights (SDR), which at the end of 2019 amounted to approximately USD 10,800 m. Access to this credit line only is granted to member countries with good economic performance, prudent policies, and a strong economic policy framework. The country has never used these resources, but it has considered prudent to count on them in the event of an abrupt cut to external financing.

The methodology adopted by *Banco de la República* to determine the adequate level of international reserves has the same rationale as the reason for the Liquidity Coverage Ratio (LCR, by its acronym in English) proposed within the Basel III surveillance framework for banks. This establishes that the liquid assets must be enough to cover liquidity needs within a predetermined term and considering a stressed scenario. Thus, the international reserves should at least cover the projection of the current account deficit plus external debt repayments over the next twelve months. With information to December 2019, the international reserves exceeded these items by close to USD 7,000 m. Besides, the international reserves, along with the LCF from the IMF, should cover such external financing needs and feasible capital outflows by residents and non-residents, a criterion that was also fulfilled at the end of 2019.

Profit of the period

In 2019, *Banco de la República* obtained an operational result of COP 7,149 thousand million as a result of income by COP 9,447 thousand million and expenditures by COP 2,299 thousand million. *Vis-à-vis* the previous year, income exhibited a COP 5,381 thousand million increase (132.3%) and expenses showed a COP 474 thousand million increase (26%).

Income earned during 2019 is explained mainly by yields from the country's international reserves, from the investment portfolio in national treasury bonds (TES), and from liquidity operations through expansion repos. The greatest income from international reserves took place mainly by the fall of the interest rates in US Government bonds during the year, which caused a valorization of the assets that make up the international reserves portfolio.

On the other hand, the higher expenses are explained mainly by the increase in the remuneration to the National Government's deposits at *Banco de la República* as a result of the greater volume of these deposits.