Introduction

The evolution of the Colombian economy during the first half of 2018 shows that the process of adjustment to the shocks of the last few years has consolidated simultaneously with an upturn in economic activity and improvement in consumer and entrepreneur confidence. The recent recovery has taken place within a context of high volatility in global capital markets, which has affected a number of emerging markets, and to which the Colombian economy has responded satisfactorily.

This coincidence can be explained by economic reasons. The macroeconomic imbalances resulting from the shock to the terms of trade and the inflationary pressures generated thereof wouldn't have allowed for a sustained recovery of growth and convergence of inflation to its target, as is currently the case. Hence the importance of reviewing the complex scenario of recent shocks and imbalances in order to understand how the economy managed to overcome them, reaching the current favorable scenario. Naturally, the consequences of the shocks still persist. The economy still hasn´t achieved its natural output level; inflation and inflation expectations still need to finish the convergence to the target; and the current account deficit must be closed further so as to ensure a sustainable level.

As has been documented in the Reports to Congress from recent years, the shocks and imbalances that the Colombian economy has had to overcome have been severe, due both to their magnitude and persistence as to their coincidence, testing the responsiveness of the macroeconomic policy. The first shock was the abrupt fall in the price of oil in the second half of 2014, which caused a sharp deterioration of the country's terms of trade with significant consequences on economic growth as well as on the external and internal equilibriums. Later on, *El Niño* caused a significant increase in food prices since late 2015, which was accentuated with the truckers' strike in mid-2016. Similarly, the collapse of the economic activity of our major trading partners in the region, also affected by the oil shock or by the fall in the prices of other commodities, weakened the demand for our export products. Finally, the tax reform in 2016, which was indispensable to ensure fiscal sustainability after the fall of national income from oil, temporarily pushed prices and weakened domestic demand, mainly due to the increase in the value-added tax (VAT) and other indirect taxes.

This sequence of shocks determined an unfavorable international environment. However, the response of the Colombian economy was smoother than in previous episodes of tension regarding the external context. This was due to the fact that the recent process of adjustment was achieved without major trauma, thanks to the sound fundamentals of the economy and adequate institutional arrangements (such as the inflation-targeting strategy and the exchange-rate flexibility; the fiscal rule; the soundness of the financial system; and the adequate level of international reserves), which retained access to external financing and market confidence. Particularly, the credibility of monetary policy, consolidated in the inflation-targeting strategy, was key to face the external shocks without causing turmoil on inflation or on the economic activity.

The macroeconomic effects of the shocks were shown in an expansion of external and public deficits, an increase of headline inflation above its 3.0% target, a reduction in the economy's growth rate, and a slight increase in the unemployment rate. The process of adjustment of the economy to the shocks has been orderly, and has allowed these imbalances to be corrected. Thus, for example, the current account deficit, which reached 6.4% in 2015, returned to 3.3% of GDP in 2017, a level that is even lower than the one recorded before the oil shock in 2013. It must not be forgotten, however, that the greatest external deficits recorded for some time resulted in an increase in the country's foreign debt, which stood at 36.8% of GDP by April 2018. This figure is higher than the one recorded five years ago (21.8% in April 2013). Hence the importance of sustaining high savings rates that allow to maintain high levels of investment without compromising the country's external sustainability. Similarly, an exporting strategy that promotes growth and diversification of external income is key to reduce the traditional dependency on exports of a few commodities and thus achieve full recovery of economic activity in the context of a sustainable external balance.

The finances of the national government were also affected by the oil shock and by the subsequent slowdown of growth. Between 2013 and 2017, government revenues from oil went from 3.3% to 0.3% of GDP, and the government's deficit increased from 2.4% to 3.6% of GDP. The increase in the deficit was lower than the fall of income from oil, which was possible due to the 2014 and 2016 tax reforms as well as to the behavior of primary public spending[1], which decreased one percentage point of GDP between 2013 and 2017. According to the government's Financial Plan, the fiscal adjustment will continue in 2018, and it is projected to reach a deficit of 3.1% of GDP. It should be noted that, over these years, the national government's debt stepped from 32.6% to 43.4% of GDP. In order to ensure fiscal sustainability, it is advisable to continue complying with the limits established by the fiscal rule regarding the structural balance (which discounts the cyclical component of the deficit).

The impact of the sequence of shocks mentioned above on the inflation rate was also considerable. Consumer price inflation, which was close to 3.0% in 2014, reached a peak of 8.97% on a yearly basis in July 2016, driven by the depreciation of the peso, the trucking strike, and *El Niño*. This weather phenomenon produced a rebound of food inflation, which rose from 5.7% to 15.7% from July 2015 to July 2016. From that moment on, the decline of headline inflation came quickly, except

1 The primary expenditures of the government exclude interest payments on the debt of total expenditure.

for a transitory increase during the second half of 2017. Several factors contributed to this significant reduction of inflation, among them the normalization of climatic conditions, the end of the pass-through of depreciation of the exchange rate to prices, and a weaker aggregate demand. The reaction of monetary policy, which increased the benchmark interest rate from 4.5% to 7.75% between September 2015 and July 2016, was another factor that played a crucial role, bringing inflation expectations to the 3.0% target.

During the first half of 2018, annual consumer inflation exhibited a significant reduction, standing at 3.2% in June. This decrease concentrated in the first three months of the year, particularly due to the disappearance of the shock caused by the increase in indirect taxes in 2017. The existence of spare capacity, the absence of pressures from the exchange rate, inflation expectations that remained close to the target, and a moderate variation in food prices also contributed to this trend. On the other hand, the decline of inflation has been limited by pressures exerted by the increase in the minimum wage and indexation to high inflation rates from previous years on the prices of some services of the economy. Some upward pressures have appeared recently as a result of increases in the international prices of oil.

Compared with the levels of June, a slight increase in yearly inflation is expected in the second half of the year. This would result from the acceleration in the annual variation of food prices associated with the usual behavior of the domestic agricultural cycle, and from increases in international prices of agricultural raw materials. Additionally, higher oil prices would exert pressure on prices of fuels and other regulated items. However, the persistence of spare capacity for the remainder of 2018 and in 2019, despite the projected recovery of economic growth, a relative slack in the labor market, and inflation expectations aligned with the target, should allow inflation to return to a decreasing trend next year and converge to 3.0%.

The adjustment of the Colombian economy to the sequence of shocks gradually regained the macroeconomic balance required to initiate the recovery of growth. Thus, the reduction of the country's risk indicators, improvement of the confidence of economic agents, and the stimulus offered by monetary policy, together with a counter-cyclical fiscal policy consistent with the fiscal rule, make up an appropriate scenario to boost economic growth. This has been reinforced by better external conditions thanks to the strength of world growth.

The reactivation of global economy has gained strength and scope. The forecasts by several international agencies outlined in this report estimate global growth in 2018 to stand between 3.1% and 3.4%, and they expect it to continue at similar levels in 2019. The acceleration of global output reflects the greater economic activity in the United States, the euro zone, China, and Japan, as well as a slight recovery in Latin America. Growth of trade and investment has played an important role in global recovery.

In this context, commodity-exporting countries such as Colombia have benefited from the recent increases in the prices of these products, which have improved their terms of trade. Particularly, the price of Brent oil increased 14.7% during the first five months of the year thanks to a favorable economic situation that strengthened its demand as well as to various geopolitical factors that affected its supply.

The Colombian economy has already begun to record the benefits derived from a better domestic and external macroeconomic environment, as shown by the result of GDP growth in the first quarter of the year, which exhibited a higher dynamism compared to previous quarters. During the first three months of the year, the economy recorded a 2.8% expansion compared to the same period of 2017 (considering the corrections by seasonality and calendar effects). Thus, the country's economy accelerated at the beginning of 2018 *vis-à-vis* the fourth quarter last year, when the annual growth rate was 1.4%.

The figures for GDP growth on the side of expenditure for the first quarter of the year show that the greater dynamics of demand was driven by the expansion of total consumption, which grew from 2.2% to 3.3% in the fourth quarter of 2017, while gross capital formation contracted 5.6%, contrasting with a growth figure of 1.3% in the last quarter last year. This suggests that growth of demand in the first quarter was not homogeneous among its components, which is due to transitory factors that might be reversed in the remainder of the year.

As for total consumption, its greater dynamism reflects the strong recovery in public consumption, which registered a growth figure of 7.2% in the first quarter. This was due to the effect of exceptional expenditure such as the costs of elections and the population census, together with a higher expenditure by regional and local governments associated with the electoral cycle. Similarly, a higher dynamism of household consumption was observed, growing 3.3% from 1.3% in the first quarter of 2017 as a reflection of the increase in consumer confidence, the fading of the effects of the increase in the VAT, and the decline of headline inflation. On the other hand, the contraction of gross capital formation seems to come from major setbacks in construction of civil works and building construction, as can be seen from the annual variation of the added value of these sub-sectors in the first quarter of the year (-8.2% and -9.2%, respectively).

The performance of all the branches of economic activity exhibited significant differences during the first quarter of the year. Those with the highest growth rates were, in order, financial and insurance activities (8.4%), and public administration and defense, education, health, and social services (7.0%). On the contrary, significant contractions were recorded in construction (-7.9%) and mining (-3.9%). Retail, agriculture, and industry showed moderate expansions.

The information available on GDP for the first quarter, along with data for the other indicators of economic activity for the second quarter, allow the Central Bank's technical staff to maintain the forecast for economic growth at 2.7% for 2018. This figure is higher than the one observed in 2017 (1.8%), although lower than the estimate of the natural output level of the economy. This reaffirms that the worst part of the effects of the shock to the terms of trade has been overcome, and that the Colombian economy would begin to record moderate (albeit sustained) expansions, which converge to its natural output in the long term.

Regarding the labor market, there were no significant changes in unemployment rates during the first five months of the year. At the national level, the unemployment rate stood around 9.5% between January and May, a figure similar to the one presented in the last four months of 2017 and slightly higher than the value for the first half of the year (9.3%). For the 13 larger metropolitan areas, the unemployment rate was stable around 10.6% and around 5.1% in rural areas, the latter slightly below the values for the first half of last year. On the other hand, the quality of employment at the national level (measured as the number of salaried and formal employees) exhibited a slight deterioration, registering a 0.5% fall in the number of salaried workers in May, compared to the levels in December 2017. On the other hand, non-salaried employment showed a 2.4% expansion. The decline in construction, which was an important source of employment in previous years, possibly impacted these indicators. The section of this Report on labor market discusses this topic in depth.

The general context herein described shows that the Colombian economy managed to correct a large part of the imbalances caused by the shocks and that it has begun to regain gradually its growth dynamics, thus providing favorable conditions for the consolidation of growth. Consequently, until April 2018, the Board of Directors continued to reduce the interest rates, having started to do so in December 2016. The convergence of inflation and inflation expectations to the 3.0% target and the persistence of spare capacity have supported this policy. Currently, the Central Bank's intervention rate is 4.25%, a figure that corresponds to a moderately expansionary monetary policy stance. The acceleration of economic growth foreseen, the expected behavior of inflation, and the long-term trend of the cost of funding of the economy explain the recent stability of the policy rate.

However, this scenario does not exclude risks and policy challenges. Although external conditions continue to be favorable in 2018, there is uncertainty about the pace of the normalization of monetary policy in advanced economies; also, regarding greater trade protectionism in some major economies; and about the possibility of a relapse in the prices of oil and other commodities.

Normalization of monetary policy in the United States and volatility of the international financial markets have affected some emerging economies. Colombia has weathered this situation smoothly until now, given that the markets have recognized the soundness of its macroeconomic policy framework and the orderly adjustment to shocks in previous years. However, normalization of monetary policy in advanced economies is expected to continue, which could generate tension on capital flows and on the cost of financing in emerging economies, especially if these events take place abruptly and are not anticipated by financial markets. This would be important for Colombia and other countries in the region, whose financial markets have been important recipients of capital flows in the last few years and have a broad base of foreign investors.

In this regard, the low currency mismatches in the balance sheets of financial intermediaries, households, and real sector firms in Colombia stand out. This feature reduces the risks on macroeconomic and financial stability resulting from strong fluctuations in capital flows and the exchange rate. In recent years, the

Board of Directors of the Central Bank strengthened monitoring and regulation of currency and term mismatches of financial intermediaries in foreign currency. This allowed for the modification of the exchange rate regime (External Resolution 01 of 2018) in order to simplify it, maintaining the risk-monitoring mechanisms and counter-cyclical instruments. One of the boxes in this Report describes the modifications to the foreign exchange regulation, explaining the general principles of the new regime, as well as the main changes and their motivations.

A relevant aspect in the current risk map is linked to the implementation of protectionist measures by some countries that could weaken global growth through a fall in international trade and the destruction of global value chains. The renegotiation of the North American Free-Trade Agreement, as well as the decisions by the Government of the United States on the imposition of tariffs on imports from China and other countries, and their response to these retaliatory measures generate threats to global commercial activity. An escalation of trade conflicts would bring a negative impact on growth, both in advanced economies as in emerging markets.

Another latent risk that prevails is the sustainability of oil prices at their current levels. The information from the oil futures market suggests lower prices in six to twelve-month horizons. However, these and other forecasts are uncertain. The future evolution of the price of oil will depend, among other factors, on decisions made by OPEC and other large producers regarding their production levels, as well as on the extension of the current pace of global growth.

In order to address these risks and retain the confidence of domestic and external agents in the country, it is necessary to preserve a credible policy framework and to maintain an appropriate level of international liquidity. The Board of Directors of the Central Bank continuously monitors the risks of international liquidity in the country to ensure that the level of reserves provides adequate coverage. The current level of net international reserves, which is close to USD $48,000 m, is appropriate to respond for the country's debt payments with the rest of the world and to finance the current account deficit. Additionally, Colombia has a line of contingent financing with the IMF, which is granted to member countries with good economic performance, prudent policies, and a strong economic policy framework. On 25 May 2018, the IMF reaffirmed the access agreement to contingent resources to Colombia, amounting to approximately USD $11,400 m. Although the economic authorities do not anticipate using these resources, they considered prudent to have them before the materialization of a strong shock to the balance of payments. A box of this report presents, besides the background of Colombia's access to this instrument, an analysis of its costs and benefits.

This Report has been structured in four sections: the first one provides an overview of the external context; the second describes the behavior of the country's main macroeconomic aggregates and presents a detailed analysis of the regional economy. The third section describes the composition of international reserves, analyzing the factors that have affected their profitability and include (as an annex) the Central Bank's international reserves management policies. The last section analyzes the financial position of *Banco de la República*, detailing the evolution of financial results to June 2018 and the projected income and expenses for the remainder of the year.

Besides the usual sections and the boxes mentioned above, this report presents two additional boxes: one about some indicators of the operation of the payments system, and another on cryptoassets. The Central Bank of Colombia manages seven payment systems and must ensure their safe and efficient operation, which is indispensable for the operation of the economy. For this reason, the availability and quality of these systems are analyzed, including some statistics on availability, a summary of events that have affected their operation, and the corrective actions taken to ensure provision of the service. Given the importance of payment systems, a section on this topic will be included in the body of the report.

Finally, the box on cryptoassets provides a definition and lists some of the features that prevent it from substituting legal tender and the payment instruments issued by financial institutions. Additionally, the box includes a brief description of the changes made by different countries in their regulatory frameworks with the purpose of mitigating the potential economic impact of the proliferation of these assets.