Introduction

During the first half of 2017, the Colombian economy continued with the process of macroeconomic adjustment described in detail in the Report to Congress published in March. The most recent information suggests that this process is entering its final stage, as the macroeconomic imbalances which resulted from the combination of the shocks experienced by the country in mid-2014 have been corrected for the most part. This has contributed to reduce the risk premia, and has created adequate conditions for the progressive relaxation of monetary policy. The first variable worthy of notice is consumer inflation, which has maintained a downward trend after July 2016, when it reached a peak of 8.97% on a yearly basis. This trend continued last June, when it reached 3.99%. The progressive decline in the inflation rate has resulted, in part, to the fading of the transitory supply shocks such as *El Niño*, the trucking strike, and the depreciation of the peso, which created a strong upward pressure on prices. On the other hand, weakening of domestic demand reinforced the decreasing trend of inflation. However, other factors, such as increases in indirect taxes and the indexation of wages and prices, created new upward pressures at the beginning of 2017. This explains that the decline in core inflation has been slower than in headline inflation, as can be observed in non-food inflation and the average of core inflation indicators, which remained above 5.0% (5.12% and 5.09%, respectively) at the end of June.

Monetary policy has been fundamental to control inflationary pressures. In the period from August 2015 to July 2016, the benchmark interest rate increased from 4.50% to 7.75%. These increases were transmitted to the other interest rates, both for deposits and loans. In the case of the latter, transmission occurred with higher intensity on interest rates to commercial credits. This timely increase contributed to reduce the demand and moderate the increase in inflation expectations, which complemented the downward influence of the dissolution of the supply shocks, in order to achieve the reduction of inflation, as outlined before.

Regarding the external imbalance, it is worth recalling that the sharp drop in the price of oil and other export commodities was reflected in a reduction close to 50% of the value of total exports between 2013 and 2016. This was accompanied by a significant decrease in the value of imports of goods, due to the weakening of domestic demand and the recomposition of expenditure toward goods of domestic origin, induced by the sharp depreciation of the real exchange rate. On the other hand, net factor income decreased due to lower profits generated by mining companies with foreign capital which operate in the country. In this context, between 2014 and 2015, the current account deficit widened from 5.2% to 6.4% of GDP. However, in 2016 there was a significant reduction of the deficit, registering 4.4% of GDP, as the fall in exports moderated and the economy advanced in its adjustment process.

In the first quarter of 2017, the current account deficit continued its decreasing trend from the previous year reaching USD 3,182 m (4.4% of quarterly GDP), compared to USD 3,546 m (5.9% of quarterly GDP) in the same period of 2016. However, it is worth mentioning that in this period, a favorable change took place in the pattern of adjustment of the current account observed so far. This time, the adjustment of the deficit was due to a recovery in exports (24.5%), in contrast with the sharp falls of importer expenses in previous years. The major external revenues coincided with an upturn in the growth rates of imports (7.1%), mainly for intermediate and capital goods. Among the current income, the increase in the exported value from the mining and energy sector stands out, reflecting the upturn in the prices of oil and other raw materials and —to a lesser extent— of the agricultural sector. This was due to the increase in the production of coffee, flowers, and bananas, which boosted the growth of the quantities sold abroad. As for services, the increased dynamics was propelled by the external income obtained from activities related to tourism and good performance of business services exports (such as legal and accounting services, and call-centers). Preliminary data suggest that the current account would have continued improving during the second quarter of this year.

Regarding the performance of the economy so far this year, GDP results for the first quarter have already been published by DANE; also, leading indicators and surveys are available, all of which allow for a preliminary assessment for the second quarter. During the first quarter of the year, the economy grew 1.1% on a yearly basis *vis-à-vis* 2.0% for 2016. In quarterly terms, economic activity reduced its annual growth from 1.6% annually in the last quarter of 2016 to 1.1% in the first quarter of 2017. Thus, versus the fourth quarter of last year, GDP contracted 0.2%, which corresponds to an annualized -0.9% rate.

As detailed in the Report, the productive sectors that registered a greater contraction during this period were: mining (-9.4%); construction (-1.4%); industry, excluding refining (-1.1%); utilities (electricity, gas, and water supply, -0.6%); trade (-0.5%); and transport (-0.3%). Although this lower performance was predictable to some extent, given the weakening of aggregate demand of the economy, in some cases the observed results were lower than expected by the technical staff, as was the case with construction (-7.1%) and civil works (3.5%). Similarly, on the side of the demand, GDP exhibits a slowdown in items as important as private consumption, which expanded at a slower pace than public consumption in the first quarter (1.0% vs. 2.1%), inverting the observations from 2016. On the other hand, gross capital formation remained virtually stagnant (0.2%), but some items, such as construction and buildings (-7.5%) and machinery and equipment (-3.9%), exhibited negative results. In this context, characterized by a weakening economic activity, the good results of agriculture (7.7%) and financial services (4.4%) stand out. The positive performance of agriculture was due to the great dynamism of coffee production and other agricultural products that recovered from the impact of *El Niño*. On the other hand, the expansion of financial intermediation contributed to this sector's growth, and given its high participation in GDP, it also contributed to the growth of the economy.

The information available for the second quarter suggests that the Colombian economy would have exhibited a low expansion, similar to that of the first three months of the year. This is shown by the survey on industry and retail published by DANE in May, for example, which suggests that the total industrial output for that month fell 0.6%, and—excluding refining—it did so by 0.8%. For the first five months of the year, the industry decreased 1.3%, and excluding refining, it contracted 3.0%. The same survey also reported that total retail sales fell 0.5% in May, and that the accumulated reduction between January and May was 1.4%. On the other hand, the consumer confidence index fell in May, as did the industrial confidence index. Something similar happened with the indicators of stock and orders of the industry, as well as with production expectations to three months, according to the results of the business opinion survey. Finally, the total area approved for construction and cement production also fell in the accumulated value for the first five months of the year.

GDP results for the first quarter and the preliminary information for the second reveal a higher-than-expected slowdown in economic activity. While the reduction of the costs of the economy is part of the process of adjustment required facing a permanent fall of national income, the figures available suggest that the balance of risks between inflation and growth could have tilted towards a greater slowdown of output.

Consistently with this assessment, since December 2016, the Board of Directors of the Central Bank of Colombia (BDBR) has been gradually reducing the benchmark interest rate, as it verified the continuity in the decline of headline inflation and its forecast, the favorable reduction of the current account deficit, and the weakening of economic activity. In its meeting at the end of June, the Board decided to accelerate the pace of reduction of the policy interest rate, approving a 50-bp reduction (bringing it to 5.75%), thus accumulating a 2-percentage point cut versus the level in November 2016 (7.75%). This reduction seeks to stimulate economic activity, but it also considers that inflation is still above its 3.0% target. Therefore, monetary policy decision-making requires balancing risks of a too-slow convergence of inflation to the target, on the one hand, and an excessive deceleration of economic activity, on the other. The cuts to the benchmark interest rate have allowed for a significant relaxation of monetary policy, but its stance is still contractionary *vis-à-vis* what is considered to be a neutral interest rate.

This Report analyzes the transmission of the 2-pp reduction in the benchmark interest rate to the financial system's interest rates. A more than proportional cut on interest rates for deposit certificates with maturities greater than or equal to 360 days is observed. For shorter periods (90 and 180 days), the degree of transmission was 60%. As for credit rates, the reduction has been fully transmitted to the interest rates on commercial loans. However, the response of credit rates to households has been slow. Particularly, interest rates for consumer loans and credit cards recorded very moderate reductions, while mortgage rates have been responding in an amount slightly higher than 30%.

The process of adjustment of the economy and the reduction of interest rates affect the liabilities and assets of financial institutions. Regarding the latter, by the end of June there was little dynamism of liabilities subject to reserve requirements, with a 7.0% increase on a yearly basis, versus the closing at the end of June 2016. As for assets, at the end of June, the gross loan portfolio in legal currency recorded a 7.0% increase, lower than the one observed on the same date in 2016. This is explained by the reduction in the annual growth rate of the commercial loan portfolio (3.5% in June 2017 vs. 13.5% in June 2016), which represents 57% of the total portfolio. On the other hand, consumer credits and mortgage loans showed 13% annual increments to June, a pace similar to the one observed in 2016. The lower growth of commercial loans (loans to businesses) is due to the economic slowdown, which has a negative impact on the demand for credit, despite the fact that its interest rates have responded better to the cuts in the policy rate.

The Report analyzes some risk measures in the financial system in order to determine how they have been affected by current macroeconomic conditions. Particularly, a follow-up is made on: credit establishments' portfolio quality (ICR) and arrears (ICM) risk indicators; liquidity risks; and those embedded in the public debt bonds portfolio. Regarding quality indicators, between April 2016 and the same month in 2017, increases over 30% were recorded for risky loans and overdue portfolio, which deteriorated both indicators when their participation in the total portfolio increased. This result was expectable due to the economic slowdown and specific shocks to certain firms, which affected the delinquency of the commercial portfolio. As for liquidity risks, it was found that the financial system has sufficient liquid resources to meet its contractual and non-contractual obligations in the short term. Related with the market risk of financial institutions' TES portfolio, to June 30, the monthly average of the value-at-risk indicator (VAR) of the financial entities' proprietary position decreased slightly *vis-à-vis* the one observed six months ago (0.5% versus 0.6%).

Another topic dealt with in this Report is the performance of the labor market. The purpose is to examine to what extent the slowdown in economic activity has impacted the recent behavior of unemployment and informality rates in the country. The analysis of the figures allows to conclude that, despite a lower economic growth in recent quarters, the labor market has not suffered a significant deterioration. In fact, according to the results of the Great Integrated Household Survey (GEIH) published by DANE, between January and May, the national unemployment rate did not exhibit significant changes, posting, on average, at 9.3%, as it had in the same period of 2016. For the 13 major metropolitan areas, the unemployment rate exhibited an increasing trend, especially compared with the average of observations from March, April, and May, whose value was 10.5% *vis-à-vis* 9.4% for the same period in 2016. However, considering that the economic activity slowed down from growing 4.4% in 2014 to 2.0% in 2016, and 1.1% annually in the first quarter of this year, it can be stated that even this recent increase of urban unemployment appears to be moderate.

In order to understand the reasons that explain the relative stability of unemployment rates, despite the marked slowdown in economic activity, the labor market was analyzed as to its supply and demand components. To do so, the trends in the Employment Rate (ER) (which measures the demand for labor) and in the Labor Participation Rate (LPR) (which measures the labor supply), were examined in the different geographical domains covered by the survey. For the national total, so far in 2017, moderate increases were observed both in the ER and in the LPR, which explains the stability of the aggregate unemployment rate. In the case of the thirteen metropolitan areas, a reduction of the ER took place during this period that was not offset by a fall in the LPR, and which led to a moderate increase in the unemployment rate. In urban areas other than the thirteen major areas, increases in the ER have been observed since March that have exceeded increases in the LPR. This explains why the unemployment rate for the average from January to May has reduced to 8.8% in those cities, compared to 9.1% in the same period of 2016. The opposing trends in the unemployment rates in these last two geographical domains have been offset, which explains the stability of the national unemployment rate mentioned above. Finally, the sectors of activity that have contributed to the average growth of employment nationwide during the first five months of 2017 were: manufacturing industry; real estate, renting and business activities; and agriculture, livestock, hunting, forestry, and fishing.

Regarding informality, for the moving quarter ending in April 2017, the downward trend in the rate of informality recorded since the middle of 2012 continued, both nationwide and in the thirteen major cities, for informality indicators related to the implementation of the regulatory framework (contribution to health and pensions). As for the informality indicator according to the total number of persons employed in firms—which considers those with payrolls of up to five employees (excluding independent professionals and Government employees) as informal—the informality rate has remained stable in the first half of the year.

This Report also examines the outlook for the main macroeconomic variables. Regarding non-food inflation, further price increases are expected for the rest of the year, although significantly lower than those observed in the first half of the year because demand is expected to continue weak and no exchange-rate pressures are expected. However, regarding food, no monthly falls as sharp as those observed in the same period last year are forecast. Therefore, annual consumer inflation it is likely to post again above 4.0%, and between 4.0% and 4.5% by the end of the year. For 2018, the projections of the technical staff suggest that yearly consumer inflation would resume its decreasing trend towards the 3.0% target.

As for growth prospects, the results observed for the first quarter of the year and preliminary information on the performance of the economy in the second suggest that some downside risks would be materializing within a 0.8% to 2.6% range, with 1.8% as the most likely growth figure for 2017[1]. This estimate is consistent

1 This forecast will be reviewed in the upcoming *Inflation Report.*

with a better performance of economic activity in the second half of the year, as the stimulus of monetary policy, the implementation of road-construction plans, and the best performance of the advanced economies begin to be reflected on the strengthening of aggregate demand and the recovery of confidence by economic agents.

Finally, the projection of the balance of payments for 2017 shows that the current account deficit would stand between 3.3% and 4.2% as a percentage of GDP, with 3.7% as the most likely figure. This forecast is framed in a context of higher international commodity prices than those recorded in 2016. This would be accompanied by a moderate recovery of external demand due to the higher expected growth of the country's main trading partners, which, added to the cumulative real depreciation of the Colombian peso, would favor Colombia's non-traditional exports.