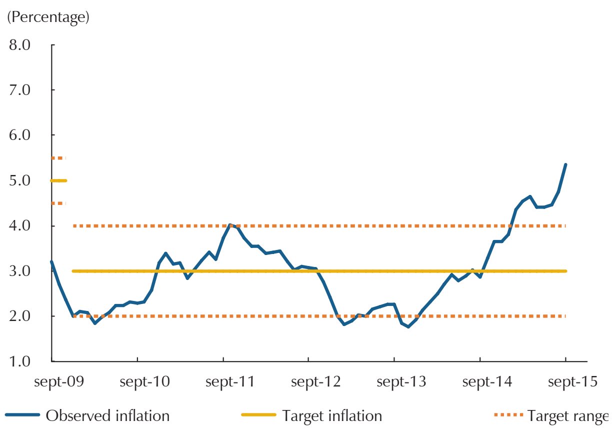
Developments in Inflation and Decisions on Monetary Policy

Graph A
Total Consumer Inflation



Sources: DANE and *Banco de la República*

Annual consumer inflation increased reaching 5.35% by September. The average of the four core inflation indicators also increased, reaching 4.89%. Much of the acceleration in inflation so far this year (Graph A) is explained by the pass-through of nominal depreciation to consumer prices, by higher costs for imported raw materials and by a lower dynamism in the food supply.

The forecasts of the technical staff at *Banco de la República* suggest inflation will surpass the current figure by the end of 2015. It is expected to remain there during the first half of 2016 and then begin to converge toward the 3.0% target. Convergence towards the target for inflation is slowed by the pass-through of part of the peso depreciation to consumer prices and by the severe *El Niño* weather phenomenon, given the direct impact both these phenomena have on prices and inflation expectations, as well as the possible activation of indexing mechanisms.

However, it is important not to lose sight of the temporary nature of the inflation rate increase. While oil prices could remain low, the impact their drop has on the exchange rate is limited. This means pressures on prices resulting from devaluation of the Colombian peso has a limit and will weaken over time. On the other hand, weather conditions are expected to normalize by the end of the second quarter of 2016. This will prompt a drop in food prices, which could be substantial if past experience is any indication. This reaffirms the temporary nature of inflationary pressures, provided inflation expectations do not become a mechanism that feeds into those pressures. This underscores the importance of keeping inflation expectations anchored to the target by means of a monetary policy that preserves its credibility. In any case, due to the extent of the shocks and the risks to the external context, the uncertainty surrounding these forecasts is unusually high. Analysts expect inflation to be 4.1% and 3.5% at one and two years ahead, and expectations derived from government debt at two, three and five years are above 4%.

In the external context, the figures on economic activity continue to reflect an external demand that is weak and lower than it was in 2014. Economic growth in the United States was moderate during the third quarter, while the Federal Reserve made no changes in the benchmark interest rates. The euro zone is slowly recovering, and economic activity in China continued to decelerate. Latin America's largest economies are experiencing low growth or declines in output, and their risk premiums remained higher than in 2014.

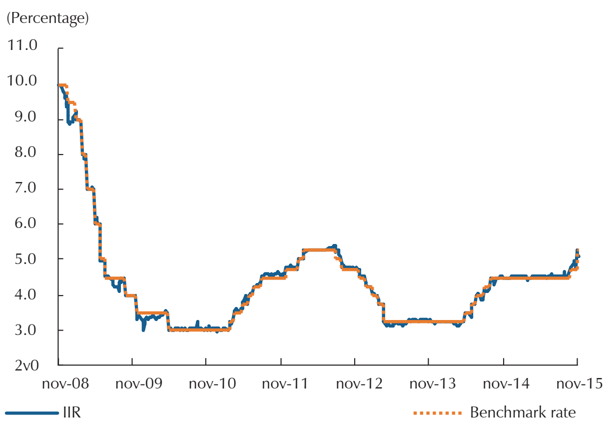
Colombian exporters have faced weaker demand than was estimated a quarter ago. International prices for oil and other commodities the country exports remained low. Consequently, the drop in the terms of trade experienced throughout the year has undermined national revenue and largely explains the higher exchange rate against the dollar.

In Colombia, the latest figures for the second quarter suggest that growth might be more than expected. Indicators for retail sales, manufacturing output and coffee, and electricity consumption, among others suggest so. The momentum in construction and civil works is expected to be good. Investment expectations indicate that this expenditure in areas other than civil works would have continued to deteriorate, although less so than in previous quarters. Therefore, compared to the last edition of this report, *Banco de la República's* technical staff revised its most likely growth forecast for all of 2015 from 2.8% to 3.0%, within a range of 2.4% to 3.4%. For 2016, growth is expected to be similar (3.0%), but within a wider range (1.5% to 4.0%).

In short, the new data show the sharp increase in prices for goods that are most affected by peso depreciation and by adverse weather conditions, continues to push up inflation, in a temporary manner. Prices for other goods and services also posted larger variations. This may be a reflection of indexation mechanisms, expectations of higher inflation in the future or cost pressures in these sectors. The behavior of these prices does not seem to indicate the existence of a significant deterioration of aggregate demand. In this context, inflation expectations have increased and the risk of a slowdown in domestic demand, beyond what is consistent with the drop in national revenue, has declined.

In this economic environment, the Board of Directors of *Banco de la República* raised the benchmark interest rate by 25 bp in September and 50 bp in October, placing it at 5.25%. The Board reiterates its commitment to the inflation target and will continue to keep a close eye on economic activity and inflation in Colombia, asset markets and the international situation (Graph B).

Graph B
Banco de la República's Benchmark Interest Rate and the Interbank Interest Rate (IIR)
(2008-2015)[a/]



A/ The figures pertain to data on business days; the last figure is for November 3, 2015.
Sources: Superintendencia Financiera de Colombia and *Banco de la República*

The Board of Directors also announced that call options would be auctioned to temper unwarranted increases in the exchange rate. This mechanism can help to unanchor inflation expectations and provide liquidity to the foreign exchange market when significant liquidity shortages arise. The auctions will be called for USD $500 million, once the representative market rate of exchange is 7 pp above its order 20 period moving average. Options are valid for one month from the date of the auction and can be exercised subject to compliance with that same condition.

Jose Dario Uribe
Governor