01 / Introduction

In Colombia, as well as in the rest of the world, the Covid-19 pandemic has seriously damaged the health and well-being of the people. In order to limit the damage, local and national authorities have had to order large sectors of the population to be confined at their homes for long periods of time. An inevitable consequence of isolation has been the collapse of economic activity, expenditure, and employment, a phenomenon that has hit many countries of the world affected by the disease. It is an unprecedented crisis in modern times, not so much for its intensity (which is undoubtedly immense), but because its origin is not economic. That is what makes it so unpredictable and difficult to manage. Naturally, its economic consequences are enormous. Governments and central banks from all over the world are struggling to mitigate them, but the final solution is not in the hands of the economic authorities. Only science can provide a way out.

In the meantime, the economic indicators in Colombia and in the rest of the world cause concern. The output falls, the massive loss of jobs, and the closure of businesses of all sizes have become daily news. Added to this, there is the deterioration in global financial conditions and the increase in the risk indicators. Financial volatility has increased and stock indexes have fallen. In the face of the lower global demand, export prices of raw materials have fallen, affecting the terms of trade for producing countries. Workers' remittances have declined due to the increase of unemployment in developed countries. This crisis has also generated a strong reduction of global trade of goods and services, and effects on the global value chains.

Central banks around the world have reacted decisively and quickly with strong liquidity injections and significant cuts to their interest rates. By mid-July, such determined response had succeeded to revert much of the initial deterioration in global financial conditions. The stock exchanges stopped their fall, and showed significant recovery in several countries. Risk premia, which at the beginning of the crisis took an unusual leap, recorded substantial corrections. Something similar happened with the volatility indexes of global financial markets, which exhibited significant improvement. Flexibilization of confinement measures in some economies, broad global liquidity, and fiscal policy measures have also contributed to improve global external financial conditions, albeit with indicators that still do not return to their pre-Covid levels.

The Global Shock

Within a context of high uncertainty, several international organizations have revealed their forecasts regarding the economic consequences of this crisis. There are, however, substantial differences among them depending on the assumptions as to the extent and duration of the pandemic.

For example, in its June review the International Monetary Fund (IMF) amended its global economy forecasts for 2020 to a -4.9% contraction *vis-à-vis* -3.0% considered in April. On the other hand, the World Bank forecasts for this year that the global economy will contract by -5.2%, while the Organization for Economic Cooperation and Development (OECD) considers a -6.0% fall. Some organisms consider more negative scenarios should there be a new outbreak of the disease. In general, global economic activity is expected to recover in 2021 at a pace slightly above 5.0%.

According to the IMF, all regions and major economies of the world would face strong contractions in 2020, except for China, which would achieve a 1.0% growth

figure. Latin America and the Caribbean are anticipated to fall -9.4%, somewhat more than advanced economies (-8.0%), but less than estimated for the euro zone (-10.2%). The strong contraction in Latin America would be due to the bad results anticipated for Brazil (-9.1%), Mexico (-10.5%), and Peru (-13.9%). Chile and Colombia, with -7.5% and -7.8% falls, respectively, in 2020, would be relatively better off. For 2021, the region would recover at a pace of 3.7%, lower than the figure for global economy (5.4%). Colombia would reach a 4.0% growth figure.

Conditions at the Onset of the Shock

In the face of such an unexpected and devastating shock as the Covid-19, Colombia was fortunate to be found at the beginning of the crisis in a strong position, both in its institutional framework as well as in its macroeconomic performance. This is a valuable asset to face the ordeal that the country is going through.

From the institutional standpoint, monetary policy under inflation targeting has achieved high credibility, thus becoming a fundamental pillar of the country's macroeconomic stability. After reaching the 3.0% long-term inflation target in 2009, its subsequent deviations have only obeyed to transitory shocks that have not affected its credibility in the medium term. The flexibility of the exchange rate, which is an inherent component of the inflation-targeting strategy, has been essential to overcome shocks such as the global financial crisis and the fall of oil prices in 2014. Subsequent studies showed that, had it not been for such flexibility, the shocks would have beaten the economy with greater force and its recovery would have taken longer[1]. Another strength of the Colombian economy lies in the strength of its financial system. The timely adoption of macro-prudential measures, the strict supervision of financial institutions, and compliance with international standards such as Basel III enabled the financial sector to be well prepared to deal with a shock of this magnitude.

Unlike some countries in the region, Colombia's economy has other characteristics that add to its strength. For example, the fact that this is not a semi-dollarized economy and that currency mismatches are not large and have been properly identified and monitored allows the economy to live together with the inevitable fluctuations in the exchange rate that result from this situation, without fear of financial or real sector bankruptcy. Finally, as was shown recently by the Ministry of Finance when launching the *Medium-Term Fiscal Framework 2020*, the National Central Government (NCG) reached in 2019 the lower fiscal deficits since 2014 and the first primary surplus since 2012, consolidating the downward path since 2016. In this context, prior to the Covid-19 shock, it was expected that public finances would continue to gradually adjust the deficit, thus complying with the provisions of the Fiscal Rule.

As for macroeconomic performance, in 2019, the country's economy grew 3.3%, a rate that exceeded our peers in the region, and widely exceeded the average for Latin America and the Caribbean, which only expanded 0.1%. This good result led the Colombian economy to almost close the negative output gap that widened after the fall of oil prices in 2014. As a result, the confidence of entrepreneurs and traders strengthened, and the credit market was stimulated. This was reflected in positive macroeconomic prospects for this year, pointing at a growth figure equal to or slightly higher than the one for 2019. Economic performance during the first two months of the year was in line with those expectations, as was shown by the economic monitoring index (ISE) produced by the National Administrative Department of Statistics (DANE),

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1 "A Crude Oil Shock: Explaining the Impact of the 2014-16 Oil Price Decline across Exporters," IMF Working Paper No. 17/160, International Monetary Fund;

"Crisis and Recovery: Role of the Exchange Rate Regime in Emerging Market Countries", IMF Working Paper, No. /10/242, International Monetary Fund.

according to which, in annual terms, the economy expanded by 3.7% in January and by 3.0% in February in the seasonally and calendar effects adjusted series.

These strengths of the country's economy, recognized by markets and risk rating agencies, do not imply that the country may be enjoying economic slack. The oil price shock in 2014 left sequels that limited the scope of economic policy at the end of 2019 and that required reforms to be overcome. For example, the gross debt of the NCG, which was 36.6% of GDP in 2013, increased to 50.3% at the end of 2019, which, compared to other countries, reduced the fiscal space to deal with a crisis as complex as the current one. On the other hand, although the pace of economic activity was recovering, there was still spare capacity in the economy. The weakness of economic activity and the distortions of the labor market led the national unemployment rate to increase from 8.4% in 2013 to 9.5% by the end of 2019. As for the external balance, the current account deficit increased from 3.2% of GDP in 2013 to 4.3% by the end of 2019. All this means that the country required to advance an agenda of structural reforms that would consolidate economic recovery, ensure fiscal sustainability, reduce the unemployment rate, and foster greater equity. The serious consequences that this crisis leaves increase the need for such reforms.

Deceleration

The good economic outlook at the beginning of the year turned over with the arrival of Covid-19. Colombia had several weeks to prepare its health system and establish management protocols, alerted by the severity of the disease. However, in the economic sphere, although the country was recovering, consequences were inevitable.

In addition, as an oil exporting country, Colombia faces a second negative shock due to the deterioration of the country's terms of trade that have resulted from the fall of oil prices, which has been reflected in a loss of national income. This fall in prices originated in the significant reduction of the demand for fuels as a result of the reduced mobility of the population, the restriction to air travel, and the contraction of global economy. Added to this were the geopolitical tensions recorded at the beginning of March between Russia and Saudi Arabia, which delayed the implementation of additional cuts in oil production by the OPEC and other producing countries. This led to expectations of increase in supply and contributed to intensify oversupply in the market.

The beginning of mandatory preventative isolation in most of the Colombian territory as of 20 March abruptly halted productive activity in important sectors of the economy. This was shown by the ISE, which exhibited for March a 4.9% fall, despite the fact that the isolation only covered the last third of the month. This was reflected in the figure for GDP for the first quarter, which only expanded 0.4% on a yearly basis, according to the seasonally adjusted series and adjusted for calendar effects (1.1% annually for the original series). This performance was significantly lower than in the fourth quarter of 2019 (3.4%) and that of the whole previous year.

The decline of the economic situation worsened in April: real industrial production exhibited an annual -35.8% contraction; total retail sales fell -42.9% on a yearly basis, and the consumer confidence index stood at a historic minimum level (- 41.3). The ISE corroborated this deterioration by registering an annual decline of output of -20.5% in April, the largest of the entire series. This contraction was mainly due to lower activity of all branches of secondary production (industry and construction, -50.1%), and tertiary (services and trade, -13.3%).

Monetary Policy Response

Banco de la República's policy response to deal with this crisis resembles that of the main central banks around the world: it was quick, it provided a significant injection of

liquidity to financial markets; it used new ways to facilitate hedging and thus alleviate the shortage of liquidity in foreign exchange markets; and it cut the benchmark interest rate significantly. Regarding the provision of liquidity, the actions taken by the Central Bank have been greater compared to those implemented by some other central banks from emerging countries.

These decisions were based on technical assessments that showed a general increase in the preference for liquidity by households and companies facing increased uncertainty. Similarly, the greater risk perception by financial intermediaries discouraged a broad group of economic agents from initiating debt portfolios. Under these circumstances, the Central Bank reacted by providing the market with ample liquidity in pesos and US dollars, while reducing the benchmark interest rate. These measures have contributed to protect the payments system and to stabilize markets such as foreign exchange and public and private debt instruments, which were under pressure. Similarly, they gave support to the credit supply and helped to reduce the financial burden on household and corporations.

The measures adopted, whose characteristics are detailed in this report, included: 1) the extension of transitory expansion operations in their amounts, counterparts, guarantees, and terms. The access to liquidity resources granted to a greater number of institutions and the inclusion of private debt instruments as collateral for liquidity tenders additional to the usual public debt should be noted; 2) the permanent injection of liquidity into the economy through the purchase of public debt instruments and securities issued by credit institutions; 3) the reduction of the reserve on bank deposits, which allowed to inject permanent liquidity to the market and to reduce intermediation costs; 4) the introduction of modern intervention mechanisms in the foreign exchange market to facilitate hedging and expand liquidity in US dollars without affecting the amount of the country's foreign reserves; and 5) the reduction of the policy interest rate by 175 basis points (bp) from 4.25% to 2.50% by the end of June, thus placing it at a historic minimum.

This considerable relaxation of monetary policy will stimulate economic activity inasmuch as the cuts to the benchmark interest rate and the expansion of liquidity be transmitted to the operation of the financial and credit markets. At the end of June, the majority of the interest rates for credits had fallen and stood at lower levels or similar to those observed before the pandemic, except for consumer draft loans, treasury commercial credits, and micro-credit. As for the amounts for credit, recent data show a significant reduction in average weekly disbursements in all modalities. This is because with the current situation they have been affected by sudden movements both in supply and demand. Such is the case mainly for consumer credit, including credit cards, whose reduction in the amounts disbursed and in rates suggests a strong contraction of demand for these resources.

Inflation

The relaxation of monetary policy has been consistent with the evolution of prices and with the 3.0% inflation target on a yearly basis. During the past few months there have been bearish pressures on prices largely due to the fall of aggregate demand and the reliefs decreed by the NCG. So, at the end of June, the annual headline inflation rate stood at 2.19%, and the average of the four core inflation indicators at 2.03%. The decline of inflation during the second quarter covered all lines of the family basket, except for health. Even the adjustment of food prices, which recorded an increase due to weather complications and to the recomposition of household spending in this group at the beginning of the quarantine, ended up receding. On the other hand, prices in the group for tradable goods, from which increases were feared due to the strong devaluation of the exchange rate at the beginning of the pandemic, recorded an annual 0.61% variation on a yearly basis at the end of June, i.e., less than one quarter of the figure in February (2.51%). Finally, at the end of June, the prices of the

basket of regulated items recorded a negative annual variation (-0.78%) as a result of the subsidies in the rates of public utilities and the decline in the price of fuels. Toward 2021, inflation would rebound once the transitional effects of the reliefs are reversed and the economy recovers gradually. In line with this, inflation expectations, which have reduced along with observed inflation, should converge to the 3.0% target.

Employment

One of the most serious consequences of the Covid-19 pandemic has been the massive loss of employment around the world and in Colombia. In our case, the labor market indicators published by DANE for April exhibited a generalized and unprecedented deterioration. The number of occupied individuals registered an annual 24.5% contraction in the national total (i.e., 5.3 million jobs) and 27.9% in the thirteen main cities (3 million jobs) *vis-à-vis* the same month in 2019. This meant the loss of about a quarter of the level of employment prior to the crisis. Additionally, the inactive population recorded a 29.0% increase (i.e., 4.3 million inactive individuals), which, in part, was due to movement restrictions that affected the search for employment. The higher inactivity contained the increase of the unemployment rate by excluding a significant proportion of the population from the labor force. Even so, the unemployment rate for the national total reached 19.9% and for the 13 cities increased to 23.8%, approximately doubling the levels in unemployment observed in April 2019.

After a strong deterioration of the labor market in April, during May, a slight rebound in the level of employment was observed thanks to the flexibilization of the isolation measures that initially allowed the restart of the construction sector and some industries, and some segments of trade and repair later on[2]. So, *vis-à-vis* April, in May, occupied individuals for the national total increased by more than 930,000 and in the thirteen cities close to 640,000. Despite this increase, the unemployment rate continued to increase, reaching 21.2% for the national total and 24.6% for the 13 cities, the highest figures in the series. This result is explained by the fact that the easing of the restrictions imposed on mobility allowed part of the inactive population to return to the labor market in search of employment. With this, the supply of workers increased more than their demand, which was reflected in increments in the unemployment rate.

In the moving quarter ending in May, the fall in the number of occupied individuals affected both salaried and non-salaried workers, which decreased by 19.5% and 20.0%, respectively, *vis-à-vis* the same period of 2019. The sectors of trade and repair, manufacturing industries, and artistic activities contributed the most to this loss of employment. Inasmuch as several productive sectors continue reactivating, the increase of occupation is expected to continue in the upcoming months. In this context, the technical staff expects that, towards the end of 2020, the unemployment rate would have retracted from the peak reached in May and stand within a range between 16.5% and 19.0%. This forecast is similar to the one recently presented by the OECD for its member countries[3], estimating 17% unemployment for Colombia at the end of 2020, under the assumption that there won´t be a new outbreak of the disease.

External Balance

The results of the balance of payments for the first quarter of the year suggest that the current account deficit would tend to be reduced as a consequence of the crisis. This

2 Decrees 593,636, and 689 of 2020.

3 OECD (2020). "OECD Employment Outlook 2020: Worker Security and the Covid-19 Crisis", OECD Publishing, Paris, available at: https://doi.org/10.1787/1686c758-en

has been so in past episodes of negative external shocks and contraction of economic activity in Colombia. In fact, for the period from January to March, the current account deficit was reduced to 3.7% of the quarterly GDP from a 4.5% imbalance for the same period in 2019. This behavior is explained by two main opposing forces. On the one hand, the deficit in the trade balance for goods expanded by USD 103 million (m) facing a more pronounced fall of exports than of imports. The decline in exports originated mainly in the lower sales of oil and industrial products, while the fall of the value of imports was due to the slowdown in household expenditure and the decrease in gross capital formation. On the other hand, unlike the dynamics of the trade balance, the deficit on factor income decreased USD 667 m due to the fall of national expenditures as a result of the reduction in the profits from enterprises with foreign investment, particularly those operating in mining and quarrying activities; oil exploitation; transport and communications, and manufacturing industries.

In this way, the improvement in the balance of factor income was the determining factor for the reduction of the deficit in the current account deficit in the first quarter of the year. This is an interesting result because it shows the appropriate counter-cyclical role that companies with foreign capital play in the stabilization of the country's external balance facing negative external shocks of great magnitude as the one we are facing.

With the same rationale, the technical staff at the Central Bank estimates that the current account deficit in 2020 would be less than 4.3% of the GDP observed in 2019, although uncertainty in this regard is high and unprecedented, which has been reflected in a wide range for this forecast. The significant reduction of consumption and private investment expected, together with the depreciation of the currency, would lead to a sharp decline in the imports of goods and services. On the other hand, the revenues from companies with foreign capital would suffer a major contraction facing the slowdown of economic activity and lower export prices of commodities, mainly oil. The correction of the current account deficit implied by these two factors would be limited by the deterioration of the country's terms of trade and the lower external demand that affect the country's exports.

Capital flows required to fund the external deficit would come from foreign direct investment, which would remain a significant source of financing, although a reduction of these resources is expected due to the fall of oil prices and other commodities as well as to uncertainty regarding the future performance of the country's and global economy. Additionally, the country would maintain access to international capital markets within an environment of low interest rates and ample liquidity. In this case, greater indebtedness expected from the public sector with the purpose of addressing the extraordinary expenses associated with Covid-19 stands out.

On the other hand, net foreign reserves totaled USD 56,623.5 m at the end of June, with an increase of USD 3,456.3 m compared to the balance recorded in December 2019 due to the purchase of foreign currency by USD 2,000 m to the NCG and to the performance of the country's foreign reserves, which at the end of June was 3.16%, excluding the foreign exchange component. In addition, on 1 May 2020, the Executive Board of the International Monetary Fund approved the renewal of the Flexible Credit Line (FCL) for an amount equivalent to 384% of Colombia's quota (USD 10,800 m). This new agreement supersedes the previous one, adopted in May 2018. The FCL is an instrument of the IMF to which only countries with solid monetary policy, fiscal and financial frameworks can apply, together with a favorable history of economic performance. Colombia has had access to this line since its creation in 2009, and until now it has not needed to use it. The country has characterized this line of credit as precautionary, deeming it as a useful tool to strengthen the capacity of the economy to face external shocks. This new agreement will help to manage external risks within a context of high uncertainty and volatility, reinforcing confidence in the markets and as a safeguard for external risks.

The current level of the country's foreign reserves covers the projection of the current account deficit for the next twelve months plus the amortization of the foreign debt. Besides, the foreign reserves, along with the FCL from the IMF, cover such external financing needs and feasible capital outputs by residents and non-residents.

Finally, on 20 April, *Banco de la República* gained access to the REPOS with the Federal Reserve (FIMA, by its acronym in English). In these transactions, the holders of FIMA accounts exchange their United States treasury bonds held in the Federal Reserve for US dollars and commit to buying back the securities on the next day along with interest. The main benefit that access to FIMA brings *to Banco de la República* is to have liquidity in US dollars should this be necessary, without having to face adverse conditions of the market nor having to definitely sell the assets of the country's foreign reserve portfolios, thus mitigating the liquidity risk.

Growth and Inflation Outlook

After the sharp fall of economic activity in April, the gradual flexibility of preventative isolation since May allowed several economic sectors to be reincorporated into the productive activity. This was reflected in some signs of recovery. Thus, the ISE by DANE registered an annual -16.7% contraction in May, lower than the one recorded in April (-20.5%), which suggests a turning point for economic activity. Within this index, the record for secondary activities (manufacturing and construction industries) stands out, as it fell -31.96% in May compared to -50.12% in April. This shows that the moderation of the fall of economic activity came from these sectors, which were the first to be reactivated. Other indicators confirm this trend. The survey of industry and trade by DANE in May recorded an annual -26.2% variation in industrial production, a figure relatively lower than the one recorded in April (-35.8%). The survey also shows that the sales of retail fell 26.8% on a yearly basis in May, somewhat less than the records in April (-42.9%), which suggests a break in the trend for this sector. Other high-frequency indicators such as energy demand and gasoline consumption coincided in showing some improvement. Considering this information, the technical staff revised its forecast scenarios for the second quarter and for all 2020.

This exercise incorporated an estimate of the impact of the social isolation measures on added value for productive sectors. The most affected would have been artistic activities, entertainment, and recreation; trade, repair, transportation, and accommodation. On the contrary, the agricultural sector and public administration, education, and health would have maintained positive annual variations, reflecting in the agricultural sector the recomposition of private spending toward food products, and for public administration, education, and health, the Government's effort to mitigate the effects of the pandemic. The possible behavior of demand and its composition was also analyzed, anticipating the strong falls in the consumption of durable goods, gross capital formation, and exports. On this basis, the estimate by the technical staff suggests a decline in GDP for the second quarter of the year close to -16%, *vis-à-vis* the same period of the previous year.

The growth forecast for the whole year assumes that gradual recovery of the economic activity will continue during the second semester, depending on the evolution of the pandemic, over which there is great uncertainty. This reactivation would be possible thanks to the gradual opening of the productive sectors, which in turn would underpin the recovery of consumers' and investors' confidence. The forecast also considers the positive impact of fiscal and monetary measures taken to date. As for external demand, it is expected to continue weak, despite the flexibilization of the social isolation measures that several countries have undertaken. With all of the above, the technical staff at the Central Bank of Colombia estimates that economic growth throughout 2020 would stand within a range between -6.0% and -10%, which would imply a significant expansion of spare capacity in the economy. The amplitude of the forecast range reflects the uncertainty regarding the magnitude of the shock in the

second quarter and on the evolution of the health situation, in the country as well as worldwide.

Regarding inflation, social distancing measures and lower levels of household spending will continue to exert downward pressures on prices. The downward trend of headline inflation has already been observed in the last few months, as shown by its 2.19% figure on a yearly basis at the end of June, falling from 3.86% in March. This trend is expected to continue in the second half of the year. For this reason, it is estimated that headline inflation for 2020 would stand within a range between 1.0% and 2.0%. Also, should this be the case, the amplitude of the forecast range reflects the uncertainty regarding the evolution of the pandemic and its effects on prices. Toward 2021, inflation would rebound once the transitory effects of the reliefs are reversed and the economy starts to recover gradually. In line with this, inflation expectations, which have reduced along with observed inflation, should converge to the 3.0% target.

Only three years away of its centenary, *Banco de la República* faces one of the greatest challenges in its history. The Board of Directors is confident that when a retrospective balance of this situation be made on such an important date, it will be said without fear mistakes that this institution stood up to the circumstances, and that the decisions made were the most appropriate for the country to overcome such a difficult ordeal.