Introduction

In an environment of greater restrictions to world trade and deterioration of global confidence, economic growth for the first quarter of the year in a number of emerging economies including Colombia was lower than expected, and the forecasts for 2019 decreased. In the first three months of the year, the Colombian economy slowed and grew less than expected, a fact explained mainly by a weaker-than-estimated public consumption and an unexpected fall in housing investment.

For the third quarter and for the rest of the year, these items are expected to record a better performance. Also, private consumption is expected to maintain its good dynamics, investment is expected to accelerate, and net exports are expected to subtract from growth. According to the forecasts by the technical staff, in 2019 the economy would grow close to 3.0% (instead of 3.5% as estimated a quarter ago). The greater dynamics of domestic demand vis-à-vis output would be reflected on a wider deficit in the current account.

Regarding prices, in the first half of 2019 inflation was close to the 3.0% target, albeit with an increasing trend due to some supply shocks that affected it. Among them was the presence of a moderate *El Niño* phenomenon due to which food prices increased, and further adjustments in the prices of liquor due to the increase in the *ad valorem* tax. The average of core inflation indicators remained below 3.0%. The greatest impact of these shocks on prices is expected in the third quarter of 2019. Also, inflation is expected to return to the convergence to 3.0% by the end of the year.

This macroeconomic context with spare capacity of the economy, along with an inflation rate that would transitorily drift from its 3.0% target, has allowed for a slightly expansionary monetary policy stance. This stance has been reflected on interest rates on loans that remain below their historical averages, in real terms.

The present *Report to the Congress* presents the vision of the Board of Directors of *Banco de la República* (BDBR) on the current economic situation and its short and medium term prospects. It also informs about the management of the international reserves and the financial situation of *Banco de la República*. The last chapter analyzes the payment systems in the Colombian economy.

External Context

The analysis of the international context contained in the first chapter of the Report is one of the key elements to assess the outlook of the Colombian economy. The first thing to note is the recent consensus of several multilateral agencies about a more conservative vision of the performance of the global economy this year. Thus, the World Bank, the International Monetary Fund (IMF), and the United Nations forecast that global economy would expand between 2.6% and 2.7% in 2019 (measured at market prices). This means 30 basis points (bp) below their initial considerations. These lower prospects are due to the uncertainty generated by the protectionist policies of the United States towards China and other countries, which has already begun to affect global trade. Also, the high leverage of the Chinese economy, geopolitical tensions, and the future of *brexit* have increased the risks on global economy, producing volatility in financial markets.

The performance of emerging economies will be affected by the deceleration of growth in advanced economies caused by a weakening of external demand and lower prices of commodities exported by these economies. In this context, the prospects for growth in Latin America and the Caribbean have also declined. For example, the IMF, in its most recent update (July 2019) of the document titled *World Economic Outlook* forecasts a 0.6% growth rate for this region in 2019, while it estimated a 2.8% expansion (including Venezuela) a year ago.

On this basis, the Central Bank's technical staff reduced its growth forecast for Colombia's trading partners in 2019 from 2.2% to 1.8%, a figure that is lower than the 2.4% figure reached by the country's trading partners in 2018. The lower external demand for Colombian exports could affect the country's terms of trade. Particularly, a lower global growth rate could weaken oil demand and reduce its price. This is inferred from the information on futures market, which suggests lower levels of oil prices in the coming quarters. However, uncertainty over these forecasts is high, and the continuity of the agreement of the Organization of Petroleum Exporting Countries (OPEC) to maintain production quotas is expected to partially offset the effect of the weakening global economy on oil prices.

The prospects of a slowdown in global economic activity have led the central banks of advanced economies to pause their monetary policy normalization processes, and recently even to express the possibility of undertaking a more expansionary monetary policy stance. In the case of the United States, the Federal Reserve (Fed) has maintained its benchmark interest rate unaltered since its increase in December. Also, the Fed stated in March that the process of asset reduction on its balance sheet would end in September. On its part, the European Central Bank (ECB) has announced that it does not anticipate increases in its intervention interest rate for the remainder of 2019. Similarly, the Bank of Japan stated that it will keep interest rates unchanged at least until mid-2020. These messages have influenced agents' expectations regarding the monetary policy stance in developed countries. In the United States, for example, investors anticipate reductions in the benchmark intervention rate by the Fed in the remainder of this year. The likelihood of a relaxation of international financial conditions has been reflected in a decline of long-term interest rates of sovereign bonds in the main advanced economies. While part of this reduction responds to the expectations of a more loose monetary policy, another part may be linked to the search for safe haven assets by international investors in the face of uncertainty on global growth.

The expectations of lower interest rates in advanced economies could encourage greater portfolio flows towards emerging economies and be partially transmitted to their financial markets. This effect could be mitigated by a greater demand for US sovereign securities, given the international uncertainty, which could cause a global appreciation of the dollar, with consequences on the exchange rates of emerging economies, as has been happening in recent months.

While favorable financial conditions are expected to contribute to improve the performance of global economy and thus provide a stimulus to emerging economies, risks to global growth and the likelihood of a trade war could create volatility in financial markets and increase global aversion to risk. This situation would attenuate the effect of the pause in the process of monetary normalization announced by the central banks in developed economies.

Economic Activity

The performance of the economic activity in Colombia during the first quarter of 2019 was affected by a strong shock to construction, which shrank at a 4.5% rate on a yearly basis. This subtracted dynamism to GDP, whose annual growth, according to seasonally and calendar effects adjusted figures, was 2.3%. This record was lower than the one obtained in the last quarter of 2018 (2.7%), posting below the technical staff's forecast. The fall of construction contrasted with the positive trend in this activity in the last two quarters of last year, when it reached 4.3% and 2.5% annual growth rates, respectively. This setback was due to the contraction in the construction of buildings (-8.8%), which was not offset by the increase of civil works during this period (4.7%).

Except for construction, all other branches of activity grew, reaching an average of 2.8% annual expansion in the first quarter, which shows that the shock was relatively isolated. Among the most dynamic, the growth of financial activities and insurance (5.5%) together with mining and quarrying (4.9%) stand out. The latter interrupted its fall in 2018 (-0.2%) thanks to the increase in oil production and a contraction lower than the one for coal. The branches of retail sales, transport, and housing (4.2%), on the one hand, and public administration and defense, education, and health (4.0%) on the other, made the largest contribution to economic growth in this period. Agriculture and manufacturing exhibited decelerations *vis-à-vis* their results in 2018.

The analysis of GDP from the point of view of spending confirms the localized nature of the shock to economic activity in the first months of the year. Indeed, total consumption, led by household spending, expanded in the first quarter at an annual rate of 4.2%, higher than the one recorded in 2018 (4.0%). However, the dynamism of total consumption was affected by the slowdown in final consumption by the Government, which grew at a 2.6% yearly rate compared with

5.6% in 2018, thus reflecting a lower level of public national and local expenditure. On its part, gross capital formation growth fell from 3.5% in 2018 to only 0.7% on a yearly basis in the first quarter of 2019 due to the 7.9% fall of housing investment, which was partially offset by growth of investment in machinery and equipment (9.8%). The combination of these events led to a slowdown of domestic demand which, according to seasonally adjusted data, recorded a 2.7% growth in the first quarter (below the 4.1% figure observed toward the end of last year and 3.9% of the aggregate for 2018). Finally, net exports subtracted dynamism to the GDP, given that the growth of total exports was slower than that of imports (1.1% vs. 13.9%).

Some recent analyses coincide in pointing out that the contraction of construction of buildings was motivated by the sluggish sales of new housing for the segments different from social interest housing (VIS, in Spanish) and priority interest housing (VIP, in Spanish)[1]. Due to this, the average waiting time in months for the sale of a new housing unit increased, which led to an accumulation of inventories in the strata of middle and upper housing, which discouraged the launch of new projects. Until inventories are normalized, no reactivation of this segment of construction is expected for the rest of the year. In the meantime, the stimulus to the recovery of this activity would come from VIS and VIP housing thanks to the greater resources and programs from the National Government. The downcycle for housing construction is expected to be completed in 2020.

However, other items of gross capital formation could contribute to improve the performance of the investment. In this regard, investment in machinery and equipment would maintain its dynamics from the first quarter. Investment in civil works would pick up with the advances in fourth generation highway projects (4G). Added to this are the projects of regional and local initiative, partially financed with resources from the biennial budget of royalties, which, in the context of the electoral cycle, would be implemented more quickly in the remainder of the year. Finally, after the complete regulation of the Financing Law, the good dynamics of investment in capital goods observed during the first quarter is expected to improve.

In addition, private consumption is expected to maintain a good rate of expansion driven by greater purchasing power supported by a greater flow of remittances from abroad, in a context of wide availability of credit at relatively low interest rates and inflation close to the target, as suggested by recent indicators of retail sales and sales of vehicles. However, recent increases in the unemployment rate could eventually limit the dynamism of private consumption. On the other hand, the slowdown in public consumption observed in the first quarter could be reversed in the second half of the year as a result of the increased implementation of Central Government resources in the context of the goals set in the *Medium-*

1 *Banco de la República*, Special Financial Stability Report: "Analysis of the portfolio and the housing market in Colombia," first half of 2019; ANIF, "Recent performance of the construction sector and new housing market," Anif's Report on the Construction Sector, No. 206, June 2019; *Corficolombiana*, "Sectoral report. Buildings: light at the end of the tunnel," 23 May 2019.

Term Fiscal Framework (MFMP, in Spanish)[2], and the progress or termination of programs in charge of regional and local authorities, as often happens at the end of their mandate.

The isolated nature of the shock that affected the pace of economic activity and its eventual reversion, especially in the case of public consumption and more slowly in housing construction, allow to expect that in the second quarter—and especially in the second half of the year—the Colombian economy will gain dynamism in a context of policy interest rates that would continue to be expansive and a wide offer of credit, two factors that would continue driving domestic demand. Additionally, it is anticipated that the positive effects of the *Ley de Financiamiento*, combined with a good performance of civil works, promote an acceleration in the pace of investment growth.

Prospects for Growth

Given the domestic and external context described above, the Central Bank's technical staff revised the growth forecast scenarios for the Colombian economy in 2019. This exercise incorporated the gap between the GDP growth observed during the first quarter of the year *vis-à-vis* the forecast for that period; it also assessed the specific characteristics of the shock, considered the leading indicators available, and incorporated the global economy scenario as outlined in the preceding paragraphs. The result was a reduction in the GDP growth forecast for 2019 from 3.5% to 3.0%. This projection considers an acceleration of economic activity during the second half of 2019. The revision of the forecast took into account, among other factors, the expected strengthening of domestic demand stimulated by a wide credit supply at low interest rates, in the framework of the stimulus provided by monetary and fiscal policy.

Inflation and Monetary Policy

Along the first half of the year, headline inflation exhibited a slight upward trend, which at the end of June led it to reach 3.43% *vis-à-vis* 3.18% last December. This increase was due mainly to the rise in food prices and in some regulated services, which is expected to be transitory. Core inflation, which partly discounts transitory shocks, fell from the beginning of the year to levels slightly below the target and remained there throughout the semester. This is what the average of the four indicators[3] monitored by the Central Bank shows, which stood at 2.96% in June, falling from 3.03% at the end of last year.

2 It should be noted that the Financial Plan for 2019 envisages an increase in total spending of 18.4% to 19.0% of GDP, which is consistent with the target deficit of 2.4% of GDP, thanks to the increase expected in total income of 15.3% to 16.6% of GDP between 2018 and 2019.

3 Core inflation indicators are: inflation excluding food; the Core 20 indicator; the CPI excluding perishable foods, fuels and public utilities; and inflation excluding food and regulated items.

Food inflation, which was the subgroup that contributed the most to the increase in headline inflation during this period, increased from 2.43% in December to 4.46% in June. In addition to the usual agricultural cycle, the upward pressure on food prices came from *El Niño*, despite its moderate intensity. In particular, meat and a number of perishable foods were affected, particularly strongly in the Caribbean region. The adoption of the multistage sales tax on soft drinks approved with the *Ley de Financiamiento* added to this pressure.

On the other hand, regulated items inflation was reduced by more than one percentage point, going from 6.37% in December to 5.33% at the end of June. However, this record still remains at high levels compared to other subgroups. Within this group, the largest adjustments have been on public utilities, particularly water supply and sewerage services, as well as energy and gas.

The moderate increase of inflation during the first half of the year, despite the supply pressures mentioned above, is explained by the existence of fundamental factors that contributed to contain price increases. In fact, due to an economic growth figure below its potential, the economy continues to operate with spare capacity, which represses the price pressures associated with the growth of spending. This same circumstance has contributed to keeping inflation expectations near the target and to prevent the pass-through of the depreciation of the peso to prices. This has allowed core inflation to remain stable around the 3.0% target, and inflation for the subgroup of non-tradable items to continue falling, reaching 3.36% in June. Finally, in the context of a slack labor market, there has been no evidence of inflationary pressures originating from increases in wage costs.

In the remainder of the year, these factors will continue contributing to moderate inflationary pressures arising from the shocks to the prices of food and of regulated items. Additionally, inasmuch as the latter lose strength, inflation should converge to its 3.0% target in 2020. However, there are still risks associated with an unforeseen devaluation that could push the prices of tradable goods, or with the endurance of the closures of the roads that could continue to affect food prices in Bogotá and other regions of the country.

In the context of a relatively stable inflation close to the target, affected only by moderate and transitory shocks during the first half of 2019, the Board of Directors maintained its policy rate at 4.25%, where it has remained since April 2018. This slightly expansionary policy stance has been offering a prolonged stimulus to the economy. This has been observed in the performance of active and passive rates so far this year, which, despite normal fluctuations due to seasonal reasons, have remained at low levels that stimulate the demand for credit, as described in this Report.

This is the case, for instance, of the growth of the total portfolio of credit establishments (7.1% on a yearly basis to the end of June), where the trend to recovery that began in the last quarter of 2018 seems to be consolidating. By type, the improvement is due mostly to the behavior of the consumer loan portfolio, which accelerated in a sustained manner along the year, and by the end of June had reached 11.8% annually. At the same time, the mortgage portfolio continues showing annual variations greater than 10%. This suggests that the credit demand by households has strengthened compared to previous years. On the other hand, to June, the commercial portfolio registered a 3.9% annual growth, accompanied by a relative stability in its interest rates.

Employment

Amidst an economic growth level below its potential and an output gap that remains negative, during the first half of 2019 the unemployment rate (TD, in Spanish) continued to show an increasing trend both nationally as well as in urban and rural domains due to a demand for labor that continued to deteriorate. According to the latest information from DANE, the total national TD moved from 10.2% in the moving quarter ending in December to 10.5% in the moving quarter ending in May. Similarly, in the thirteen metropolitan areas, the change recorded was from 11.3% to 11.5%, and in rural areas from 5.5% to 6.6%. For the national total, the increase in the unemployment rate was due to the fact that between January and May, the number of employed exhibited an average annual variation of -0.7%, while the working age population (PET, in Spanish) expanded at 1.3%. As a result, the employment rate (TO, in Spanish) was reduced. The increase in the unemployment rate would have been greater, had it not been for the fact that the labor force participation rate (TGP, in Spanish) was also reduced[4].

By branch of activity, the greatest job losses have occurred in the agricultural sector, which accounts for nearly 15% of the total employed individuals in the country and generates 60% of employment in rural areas. This phenomenon originated mainly by the falls in employment in the sub-branches of transitory crops and cereals (mainly rice) and oilseed, fruits, and nuts crops. As for the urban realm, real estate activities and services for enterprises subtracted the most from the number of employed individuals, especially in the sub-branch of real estate activities. Contrastingly, construction and community, social, and personal services were the branches with best records.

Regarding variations in the quality of employment, the figures to May for the national total show that the decline in occupation is the result of a reduction of non-salaried employment (-5.2%) that exceeds the expansion of salaried employment (3.4%). This behavior was also present in the thirteen areas, for which salaried employment in the moving semester ending in May exhibited an annual 0.5% expansion, and non-salaried employment -1.0%. The slight expansion of salaried employment in the cities is mainly due to the growth of skilled labor forces, given that unskilled labor contracts. Finally, the rate of informality presents

4 The relationships described are better understood with the following formulas:

Unemployment rate (*TD*) = 1−[*Employment Rate* (*TO*) / *Labor Force Participation Rate* (*TGP*)].

Employment Rate (*TO*) = *No. of Employed Individuals / Working Age Population* (*PET*).

Labor Force Participation Rate (*TGP*) = *Currently Active Population* (*PEA*) / *Working Age Population* (*PET*).

mild reductions in the national total, which suggests a slow recomposition of employment in favor of one of a higher quality.

External Balance

As noted, GDP results for the first quarter of 2019 showed that the net external demand (exports - imports) subtracted from the growth figure of the economy, consistent with the fact that domestic demand grew 2.7%, but GDP only did so at 2.3% (according to seasonally adjusted figures). It is important to understand this phenomenon, which had already happened in 2018, and will continue taking place in the future. One way to do this is with the figures from the balance of payments, particularly with the balance in the current account, which is monitored quarterly by the Central Bank. Naturally, these figures are not directly comparable, given that the balance of payments is calculated in US dollars and national accounts in pesos, and that the exchange rate stands between them, but also a series of deflators that convert nominal GDP values into real magnitudes. Even so, the analysis of the balance of payments offers a complete explanation of the transactions of the country with the rest of the world, which ends up affecting economic growth.
In the first quarter of 2019, the current account deficit as a share of GDP was 4.6%, a figure higher than the one observed in the same period the year before (3.5%). The widening of the current account deficit was mainly explained by the deterioration of the trade balance, due to the fact that imports of goods grew at an annual 9.9% rate, while the value of exports only grew by 0.4% annually. To some extent, the increased demand for imported goods reflects the underlying dynamics of the economy in activities other than construction, as noted earlier. On the other hand, the low dynamism of external sales is framed within a context of lower export prices and a slowdown in the pace of growth of the country's main trading partners.
The funding for this current deficit originated mainly in direct investment flows and in the liquidation of external assets. The amount of foreign direct investment (FDI) amounted to USD 3,335 m, 17.5% higher than the average over the past four quarters (USD 2,838 m) and to than the one observed a year ago (USD 1,840 m). The country received additional resources on account of the liquidations of external assets for USD 2,682 m (both deposits and portfolio investment), 60% of them originated in private sector enterprises and the remaining 40% in the public sector.
For 2019, the current account deficit is expected to stand around 4.4% of GDP, which would mean a widening *vis-à-vis* the 3.9% deficit in 2018. This forecast considers the low growth figure expected for global demand, which would be reflected in a greater deficit in the country's trade balance. This would be the result of imports maintaining their positive growth path as long as domestic demand is strengthened, combined with a slow growth of exports affected by their low prices and the meager performance of our trading partners.

Exchange Rate

If the nominal exchange rate is understood as the price of an asset (in US dollars) in terms of another (in pesos), the frequent volatility of this variable is not surprising, being exposed to domestic and external shocks that change investors' expectations about prices and with them their decisions with respect to the participation of every currency in their portfolio. Beyond that, the exchange rate also depends on the risk perception of economic agents, which is affected by: the sustainability of the debt; the external balance; the fiscal viability; inflation expectations; international commodity prices; and other relevant macroeconomic variables. Hence the difficulty to predict the course of this variable.

The evolution of the nominal exchange rate in Colombia in the first half of the year is a clear example of such volatile behavior. Having exhibited an upward trend during the last months of 2018, the exchange rate of the peso vis-à-vis the US dollar was revalued in the first quarter of 2019 by the increase in the price of oil and the announcements of the Fed suggesting a less contractionary monetary policy. This behavior was reversed during April and May, a period in which the peso depreciated facing the strengthening of the US dollar (although the depreciation was greater than in other countries of the region). In June, the depreciation reverted in the midst of a more favorable scenario in emerging economies and facing signs of greater liquidity in the United States. Fluctuations of the nominal exchange rate in a flexible exchange-rate regime such as the Colombian should not arouse greater concern, especially when the percentage of currency mismatches of Colombian firms is very low, as has been documented by the technical staff5. As the economic literature has repeatedly demonstrated, the adjustments to the exchange rate contribute to cushion the effects of external shocks, thus favoring macroeconomic stability.

Foreign Reserves

This Report presents several indicators of international reserves that seek to measure their response capacity facing external shocks or speculative attacks. To do this, the ratio between the amount of reserves and various aggregates such as external debt, debt service, current account deficit, M3, and GDP is calculated. By producing standard measures, such indicators are also useful to produce international comparisons. In general, the results of this exercise show that the country's current amount of international reserves is sufficient to meet the amortization of the foreign debt, finance the current account deficit, and continue importing for 9.5 months in the event end of a total closure of external markets. On the other hand, the comparison of these indicators with those of other countries in the region such as Brazil, Chile, Mexico, and Peru shows that Colombia has always been at an intermediate point. The country's adequate international liquidity contributes to improve market confidence, which is reflected in lower risk premia.

The amount of net international reserves of around USD 52 billion is complemented with a line of contingent financing with the IMF (flexible credit line: LCF, in Spanish) which was renewed on 25 May 2018 and was reaffirmed on 20 May 2019, amounting to approximately USD 11.4 billion at a two-year term. Considering the temporary nature of the LCF, at its session in September 2018, the BDBR decided to initiate a program of gradual accumulation of international reserves through the mechanism

5 Currency mismatches are understood as an economic agent's difference between assets and liabilities in US dollars. This concept extends to the ability to generate income in US dollars that can cover obligations in that currency.

of put options auctions. This program was extended until last 31 May, when the Board decided to suspend it in order to assess its impact on the behavior of the exchange market. With this program, USD 1.878 billion were accumulated. Looking to strengthen the accumulation of reserves, and taking into account that the National Government planned to perform some monetization of US dollars in its financial programming of 2019*, Banco de la República* bought USD 1 billion to the National Directorate of Public Credit and National Treasury on 1 February 2019 at the market rate in force on that day. Thus, reserves were accumulated for a total of USD 2.8784 billion since September 2018.