

DEVELOPMENTS IN INFLATION AND DECISIONS ON MONETARY POLICY

Global growth remains weak and foreign demand for Colombian products will likely see more growth in 2016 than in 2015. The price of oil fell 33% between September 2015 and January 2016. This drop implies further deterioration in the country's terms of trade and national income. In this environment, and with the onset of monetary tightening in the United States, Colombia's risk premium increased and the peso devalued 6.9% against the dollar.

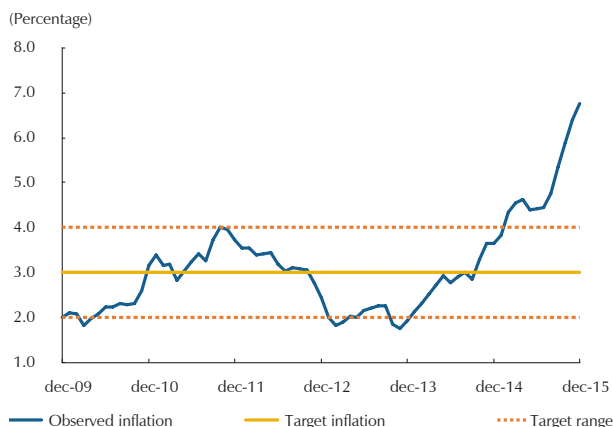
The behavior of foreign trade and the country's financial account reflect the weakness in external demand, the drop in oil prices and the higher exchange rate. Exports in dollars fell 34.9% annually during 2015, mainly because of the plunge in foreign sales of mining products (-46.5% annually). Between January and November of that year, the annual decline in the value of imports was 15%. The widening trade deficit in goods explains much of the current account deficit in 2015, which was close to USD 19 billion. This deficit is expected to be reduced to about USD 16 billion in 2016, given a forecast drop in imports of goods and services, fewer remittances of profits by foreign companies and the recovery anticipated for industrial exports.

The latest available figures suggest output growth during the fourth quarter of 2015 would have been similar to what it was in the third quarter. Domestic demand would have slowed, especially because of the projected standstill in investment and lower consumption of consumer durables. Net exports would have contributed positively to growth. The most likely forecast, for all of 2015, is 3% growth, within a range of 2.8% to 3.2%.

The Bank's technical staff expects output growth between 1.5% and 3.2% during 2016, with 2.7% being the most probable rate. This percentage reflects domestic demand that would continue to adjust to lower national income, due to average oil prices, which are expected to be 34% less in 2016 compared to their average for 2015. Added devaluation of the peso is expected to reduce imports in favor of local production and to encourage exports.

Annual consumer inflation was 6.77% in December 2015, and the average of the four core inflation measurements stood at 5.43%. The hike in infla-

Graph A
Total Consumer Inflation



Sources: DANE and Banco de la República.

tion during 2015 is explained largely by the partial pass-through of nominal depreciation to consumer prices and the cost of raw materials, as well as by the sharp increase in food prices due to *El Niño* weather. Analysts expect inflation to reach 4.5% and 3.7% at horizons of one and two years, while the expectations embedded in government bonds for two, three and five years place it above 4.5 % (Graph A).

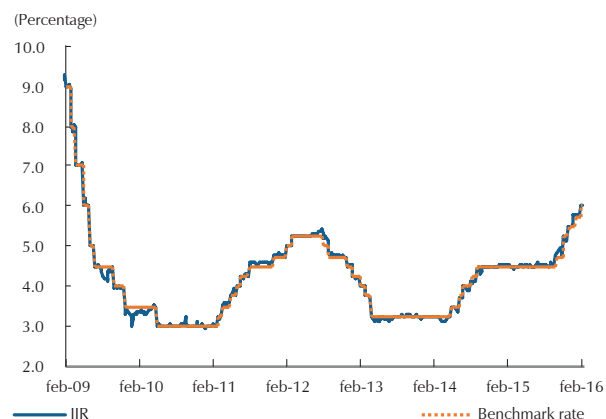
Although the pass-through of peso depreciation to consumer prices has been historically low, the current exchange rate is unusually high and persistent and could continue to have a lagged effect on prices for imported goods and services. Similarly, the decline in the supply of food is expected to continue up until the second quarter of 2016, when the weather should return to normal. In this context, and despite the fact that both are transitory shocks, they can continue to exert a direct negative impact on prices, affect inflation expectations and trigger unwanted indexation mechanisms.

In this environment, the forecasts developed by the technical staff, based on an active monetary policy, suggest annual inflation will continue to rise until mid-2016 and then begin to converge towards the target of 3.0%, which should be reached in 2017.

The new information indicates the larger-than-expected rise in food prices and the additional hikes in the exchange rate, mainly related to the more pronounced drop in oil prices in recent months, continue to exert upward pressure on inflation. At the same time, inflation expectations remain high, and there is still a moderate risk of a slowdown in domestic demand beyond what is compatible with the decline in national income.

Given this economic environment, the Board of Directors decided in October to raise the benchmark interest rate by 50 bp to ensure inflation will converge towards the target range in a two-year horizon. With additional increases of 25 basis points each at the Board meetings in November and December 2015 and in January 2016, the benchmark rate is now 6% (Graph B).

Graph B
Banco de la República's Benchmark Interest Rate and the Interbank Interest Rate (IIR) (2009-2016) ^{A/}



A/ The figures pertain to data for business days; the last figure is for 15 February 2016. Sources: Financial Superintendence Of Colombia and Banco de la República

On 23 December 2015, in light of the liquidity conditions in the exchange market, the Board decided to lower the limit (from 7% to 5%) for activating call-option auctions on international reserves and exercising these options. The other conditions for this mechanism were left unchanged.

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Governor