

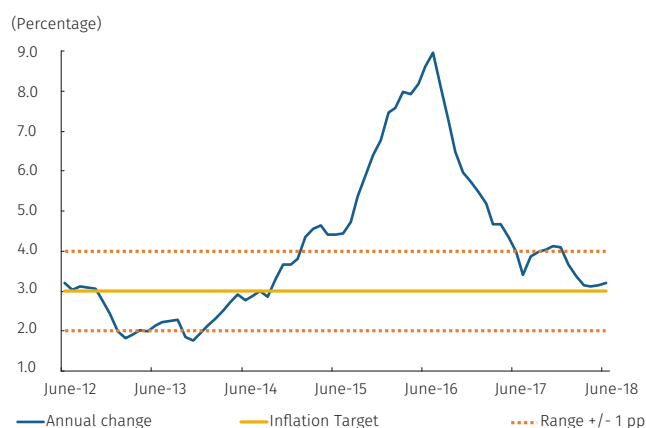
Evolution of Inflation and Monetary Policy Decisions

During the second quarter of 2018, inflation and inflation expectations, as well as several of the core inflation indicators, tended to stabilize and stood close to the 3.0% target. In that period, the economy's growth would have been low, although improving, with a spare capacity that would have widened *vis-à-vis* 2017.

In June, the annual variation in the consumer price index (CPI) and the average of the core inflation indicators were 3.2% and 3.3%, respectively,

figures similar to those registered in April (Graph A). Food, as well as those goods and services most affected by the increase in gasoline prices and by the exchange rate, were the groups that made the largest contribution to the increase of inflation. This behavior was offset by the slower pace of the CPI increase for non-tradable goods excluding food and regulated items, which has been slowing down since the beginning of the year. In the second quarter of 2018, inflation expectations showed no significant changes and remained somewhat above the target. Analysts' expectations point to 3.4% and 3.3% inflation figures in December 2018 and 2019, respectively. Those embedded in public debt bonds to two, three, and five years are within a range between 3.0% and 3.4%.

Graph A
Headline Consumer Inflation



Sources: DANE and Banco de la República.

The behavior of inflation and its expectations took place in the context of a negative output gap, with a dynamic domestic demand that would have recovered in the second quarter, but that still exhibits low increases. The indicators of retail sales, consumer confidence, and imports of consumer goods in US dollars suggest that household spending in the second quarter would have been more dynamic than in the first. On the other hand, estimates of imports of capital goods in constant pesos indicate that they would have registered a less-negative annual growth rate than the one observed in the first three months of the year.

With this, the Central Bank's technical staff considers that economic growth in the second quarter (seasonally adjusted and corrected for working days) would be around 2.6%. This estimate assumes that the strong growth in public consumption recorded in the first three

months of the year would have been transitory and that it would moderate in the second quarter. Also, that investment in civil works will fall less than at the beginning of the year. The contribution of net exports to growth would have been lower. A better dynamics of absorption would have taken place in an environment of recovery in the terms of trade and with a current account deficit that would have widened in US dollars and as a share of GDP. The latter estimate suggests that the closure of the external imbalance would have been slower than projected.

Calculations indicate that the real policy interest rate and that for commercial credit, mortgages, and consumer credit (except credit cards) are at levels below their averages for the past 10 years. This takes place within a context in which the reductions in the policy rate would have been completely transmitted to the rates of commercial credit and mortgages, while the transmission to the consumption rates has not yet been completed.

For the rest of the year, the new figures and forecasts of economic activity in the United States, the euro zone, and some countries in the region suggest that external demand will continue to increase, but at a rate somewhat lower than expected one quarter ago. The futures market at six and twelve-month horizons indicates that the oil price will decrease, but to levels still way higher than a year ago. Should this materialize, the terms of trade would remain at current levels and, together with the dynamics expected from the country's trading partners, would continue to favor the recovery of external income.

It is likely that the cost of external financing will continue to increase, as has occurred since mid-last year, as a result of the expected normalization of monetary policy in the United States and in other developed economies. In addition, with the country's external imbalance not yet completely corrected, there is a risk that other factors that exert upward pressures on the country risk measures and on the exchange rate become strong, such as an unexpected increase in global interest rates or in the risk premia of emerging markets, or a reversal of international oil prices.

Growth of the economy in the second half of the year is expected to be similar to the figure estimated for the first half (2.7%), although with a more homogeneous sectoral behavior. The increase in total consumption would be somewhat lower, with a more dynamic household spending and a lower increase of public consumption. Investment would grow, but at a low rate. Domestic demand would continue to recover slowly, and the contribution of net exports would be low, but positive. With this, the technical staff maintained its 2.7% growth projection for 2018. Our calculations suggest that the spare capacity will be somewhat wider in 2018 than in 2017.

The monetary policy actions taken so far and the spare capacity of the economy should contribute to the convergence of inflation to 3.0%. However, there are risks that might slow down this process significantly. One of them is a more pronounced increase in the price

of food than projected for the rest of the year. It has not been ruled out that some regulatory changes and other supply shocks (e.g., the increase in garbage collection rates) may generate increases in the prices of public utilities and maintain the annual variation of the CPI for regulated items high in the second half of 2018. There is also the risk of a stronger-than-expected depreciation of the peso that would be passed-through to domestic prices.

Based on this information, the Board of Directors considered the following factors in its decision:

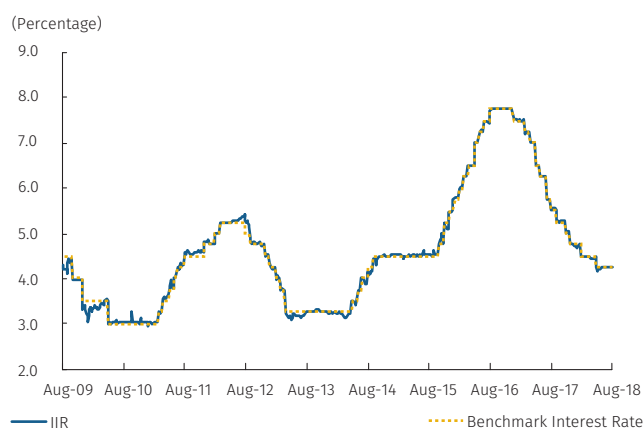
- Uncertainty about the pace of recovery of economic activity. On the one hand, it is projected that spare capacity would expand in 2018. On the other, if the price of oil remains at current levels for an extended period or the increasing trend in confidence persists, the dynamics of aggregate demand could be greater than expected. Uncertainty in this regard is high.
- The stability of inflation and its expectations above the target, and some risks that could push the inflation upwards and delay its convergence to 3.0%. Among them, a stronger-than-expected depreciation of the peso that would be passed-through to domestic prices. Once again, uncertainty about these scenarios is high.

In this environment, after assessing the situation of the economy and the risk balance in its meetings in June and July 2018, the Board deemed appropriate to maintain the benchmark interest rate at 4.25% (Graph B).

The Board of Directors will continue to carefully monitor the behavior of inflation and the projections of economic activity and inflation in the country, alongside the international situation. Monetary policy will depend on the new information available.

Juan José Echavarría
Governor

Graph B
Banco de la República's Benchmark Interest Rate and Interbank Interest Rate (IIR)
(2009-2018)^{a/}



a/ The figures correspond to data from working days; the last figure is from 2 August 2018. Sources: Office of the Financial Superintendent of Colombia and Banco de la República.