
INFLATION REPORT

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INFLATION REPORT

* Presented by the technical staff to the Board of Directors for its meeting on 26 July 2019.

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REPORT



Prepared by:
Programming and Inflation Department
Deputy Governor's Office for Monetary Policy and Economic Information

Editor's Note

Banco de la República is currently in the process of modernizing its Inflation Report with the goal of communicating an analysis of economic conditions and forecasts for the economy in a better way. For that reason, as of the October edition, the report will be structured as follows:

- 1. Summary**
- 2. Macroeconomic Forecasts**
 - 2.1 The External Context**
 - 2.1.1 External Demand
 - 2.1.2 External Prices
 - 2.1.3 International Financial Markets
 - 2.2 The Domestic Context**
 - 2.2.1 Inflation
 - 2.2.2 Economic Activity
 - 2.2.3 Balance of Payments
- 3. The Current Economic Situation**
 - 3.1 Behavior of Inflation and Prices**
 - 3.2 Growth and Domestic Demand**
 - 3.2.1 GDP with respect to Spending
 - 3.2.2 GDP on the Supply Side and Sector Indicators
 - 3.3 The Labor Market**
 - 3.4 The Monetary and Financial Market**

This report (July) is a temporary and partial version of the document in its new format.

Juan José Echavarría
Governor



Office of the Deputy Technical Governor

Hernando Vargas

Deputy Technical Governor

Office of the Deputy Governor for Monetary Policy and Economic Information

Andrés González

Chief Officer

Programming and Inflation Department

Carlos Huertas

Director

Inflation Section (*)

Adolfo León Cobo

Head

Édgar Caicedo

Camilo Cárdenas

Juan Pablo Cote

Franky Galeano Ramírez

Nicolás Martínez

Carlos Daniel Rojas

Macroeconomic Programming Section

Julián Pérez

Head

Luis Hernán Calderón

David Camilo López

Andrea Salazar Díaz

Advisors and Associate Researcher with the Programming and Inflation Department

Celina Gaitán

Sergio Restrepo

Daniel Parra

Macro-Economic Models Department

Diego Rodríguez

Director

César Anzola

Juan Camilo Méndez

Santiago Forero

Nicolás Moreno

Consultant and Researchers associated to the Macro-Economic Models Department

Aarón Garavito

Alexander Guarín

José Vicente Romero

(*) The following individuals participated in the preparation of this Report: Eliana González, Head of the Statistics Section; Juan José Ospina, Consulting Head, and Juan Sebastián Corrales, Leading Professional from the Public Sector Section; Felipe Lizarazo and Cristian Rojas, student interns.

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01

Macroeconomic Forecasts

1.1 Inflation Forecast

Headline inflation is expected to increase temporarily in the coming months due to supply shocks, which should begin to revert at the end of the year. In the second quarter, annual consumer inflation was slightly above the 3.0% target, higher than anticipated in the previous report. As will be explained in the following chapter, this was the result of shocks to food and tradable prices, which were not fully envisioned in the March report. During the third quarter, these shocks would add to the pressure on food prices caused by closure of the highway between Bogotá and Villavicencio. All these increases, however, are transitory and would begin to subside as of the fourth quarter of the year.

The baseline forecast suggests inflation will gradually converge towards the target in 2020. By the close of 2019, inflation will be above 3.0%, but should fall during 2020 to finish the year slightly below that figure. This will occur in a context where pass-through of the exchange rate would continue to be moderate, the product gap would close gradually, despite remaining in negative territory, and the scenario would be one of no anticipated significant pressure on wage costs.

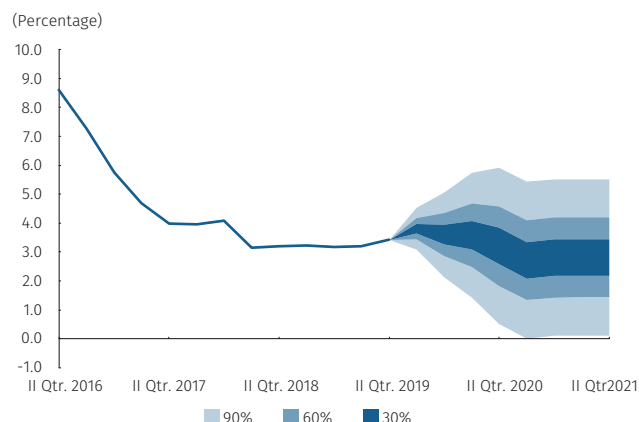
Chart 1.1 summarizes the results of the forecast exercise for the central path of headline consumer inflation, together with the respective confidence interval (Fan Chart¹). According to that interval, the probability of headline consumer inflation being somewhere between 2.0% and 4.0% by the end of 2019 is 64.2%.

¹ As of this report, fan charts are published with symmetric percentiles on the baseline forecast path for a horizon at eight quarters. The percentiles are calculated on the basis of a normal distribution, the variance of which is the mean square error of the forecasts. The previous fan charts were asymmetrical and the biases depended on the balance of risks that the technical staff felt could materialize during the same forecast horizon.

The forecast exercise shows that core inflation (excluding food and regulated items) will increase in the coming months, but will remain below the target within the forecast horizon (Graph 1.2).

For the tradable basket, the adjustments in liquor prices brought on by the *ad valorem* tax hike, coupled with higher depreciation during the second quarter, led to an upward revision of the path anticipated for the remainder of 2019. The effect of the tax should begin to dilute as of the third quarter of this year, inasmuch as partial reversal of this measure takes effect as of July. Even so, the annual variation in this basket of goods will continue to increase slowly within the forecast horizon, driven by moderate pressure from the exchange rate. With respect to the consumer price index (CPI) for non-tradables, there are unlikely to be changes in the behavior of this item during the remainder of 2019 and in 2020, partly because of indexing factors and a negative gap. Given the foregoing, the CPI excluding food and regulated items would accelerate slowly as of the second half of 2019, but would adjust at rates below the target throughout the forecast horizon.

Graph 1.1
Consumer price index ^{a/, b/}
(Fan chart of the annual percentage change)

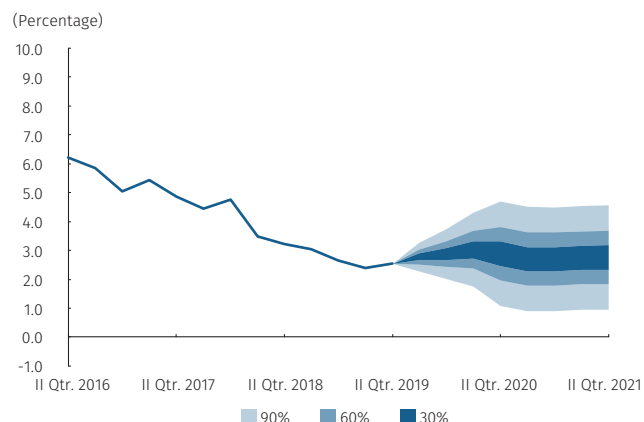


a/. The chart shows the symmetric intervals at 30%, 60% and 90% confidence on this path for a horizon at eight (8) quarters. These intervals are constructed on the basis of the forecast errors of the forecast from the technical staff's models, evaluated recursively in each quarter during the period from 2011 to 2018. The forecast errors are estimated for horizons between one and four quarters. These last errors are maintained for the calculations of intervals at horizons between five and eight quarters.

b/ The results imply an active monetary policy in which *Banco de la República's* benchmark rate is adjusted to ensure the inflation target is met.

Source: *Banco de la República*.

Graph 1.2
Consumer price index excluding food and regulated items ^{a/, b/}
(Fan chart of the annual percentage change)



a/ The chart shows the symmetric intervals at 30%, 60% and 90% confidence on this path for a horizon at eight (8) quarters. These intervals are constructed on the basis of the forecast errors of the forecast from the technical staff's models, evaluated recursively in each quarter during the period from 2011 to 2018. The forecast errors are estimated for horizons between one and four quarters. These last errors are maintained for the calculations of intervals at horizons between five and eight quarters.

b/ The results imply an active monetary policy in which *Banco de la República's* benchmark rate is adjusted to ensure the inflation target is met.

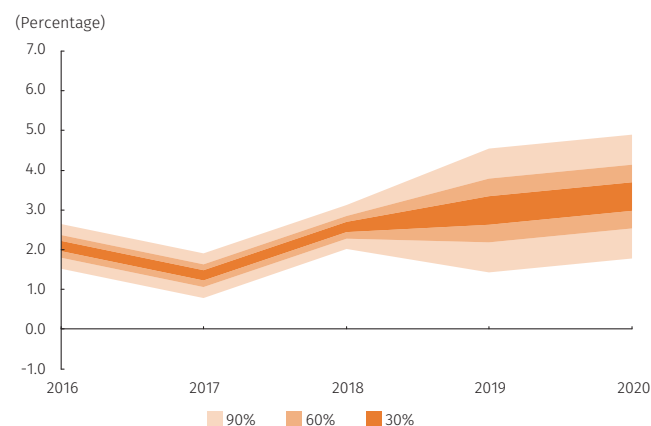
Source: *Banco de la República*.

1.2 Economic Activity

After the slowdown observed in the first quarter, a recovery in economic growth towards rates somewhat higher than the potential is expected as of the second half of the year. The shocks facing growth (see Chapter 2) would have begun to revert gradually as of the second quarter, allowing annual growth to accelerate during that period. Consequently, the economy should gain dynamism in the second half of the year, thanks to more of a recovery in

government consumption and investment in civil works, and to the fact that private consumption and investment in machinery and equipment are expected to post growth rates similar to those observed in first quarter. The results for the baseline forecast on gross domestic product (GDP) and its confidence interval are outlined in charts 1.3 and 1.4.

Graph 1.3
Annual GDP^{a/, b/}
(Fan chart of the annual percentage change)

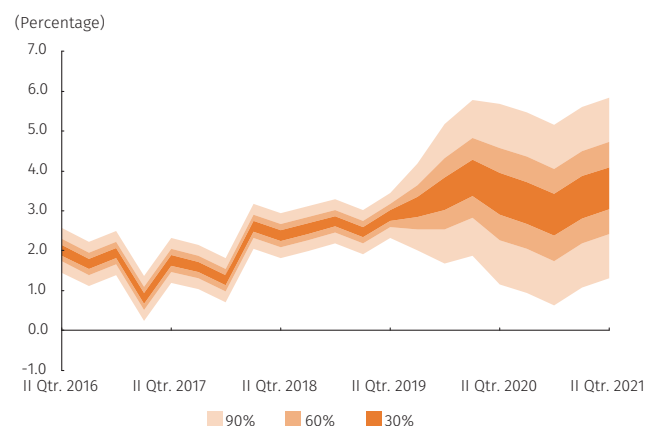


a/. The chart shows the symmetric intervals at 30%, 60% and 90% confidence on this path for a horizon at eight (8) quarters. These intervals are constructed on the basis of the forecast errors of the forecast from the technical staff's models, evaluated recursively in each quarter during the period from 2011 to 2018. The forecast errors are estimated for horizons between one and four quarters. These last errors are maintained for the calculations of intervals at horizons between five and eight quarters.

b/ The results imply an active monetary policy in which *Banco de la República's* benchmark rate is adjusted to ensure the inflation target is met.

Source: *Banco de la República*.

Graph 1.4
Quarterly GDP^{a/, b/, c/}
(Fan chart of the annual percentage change)



a/. The chart shows the symmetric intervals at 30%, 60% and 90% confidence on this path for a horizon at eight (8) quarters. These intervals are constructed on the basis of the forecast errors of the forecast from the technical staff's models, evaluated recursively in each quarter during the period from 2011 to 2018. The forecast errors are estimated for horizons between one and four quarters. These last errors are maintained for the calculations of intervals at horizons between five and eight quarters.

b/ The results imply an active monetary policy in which *Banco de la República's* benchmark rate is adjusted to ensure the inflation target is met.

c/ Seasonally and calendar adjusted series

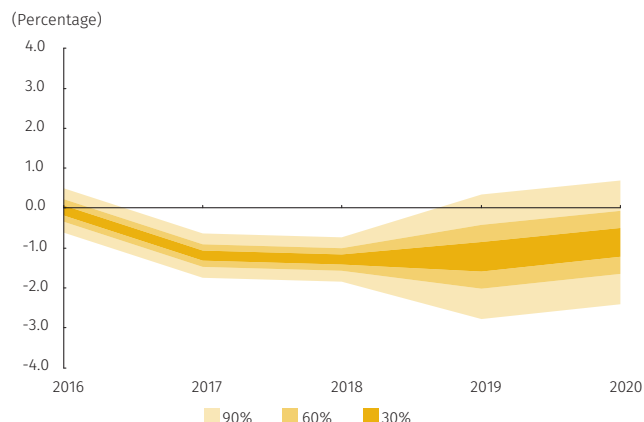
Source: *Banco de la República*.

Given the foregoing, growth during 2019 is still expected to be greater than in 2018 (2.6%), but less than was anticipated in the March edition of this report (3.5%). This forecast implies an increase in domestic demand similar to the one last year, weak exports and a net external demand that will subtract from GDP once again.

The economy will continue to gain dynamism in 2020. During that year, as in 2019, it will continue to benefit from broad domestic financial conditions. Added to this would be the positive impact of the *Ley de financiamiento*, the continuation of important projects for public works, and the reactivation of housing construction. Thanks to this, and the fact that external financing conditions should remain relatively favorable, the country's economy is expected to perform better. However, the estimate for economic growth in 2020 was revised downwards compared to the forecast in the previous edition of this report, taking into account the negative effects of added global uncertainty about investment decisions. A slowdown in government consumption is contemplated as well, consistent with less momentum in spending by new regional and local administrations (as is usual during the first year of their mandate) and with the reduction contemplated in the preliminary draft of the General National Budget (GNB) presented for next year.

In accordance with previous forecasts for growth, the output gap would close gradually as of the second half of the year, although at a slower pace than was estimated in the previous report. The negative demand shocks that affected the Colombian economy in the first quarter of 2019, together with the downward revisions in growth projected for 2020, made the output gap more negative than was estimated previously (Chart 1.5).

Graph 1.5
Fan chart of the Output Gap^{a/, b/}



a/. The chart shows the symmetric intervals at 30%, 60% and 90% confidence on this path for a horizon at eight (8) quarters. These intervals are constructed on the basis of the forecast errors of the forecast from the technical staff's models, evaluated recursively in each quarter during the period from 2011 to 2018. The forecast errors are estimated for horizons between one and four quarters. These last errors are maintained for the calculations of intervals at horizons between five and eight quarters.

b/ The results imply an active monetary policy in which *Banco de la República's* benchmark rate is adjusted to ensure the inflation target is met.

Source: *Banco de la República*.

Box 1 The Dynamics of Government Consumption in 2019

Juan José Ospina
Juan Sebastián Corrales*

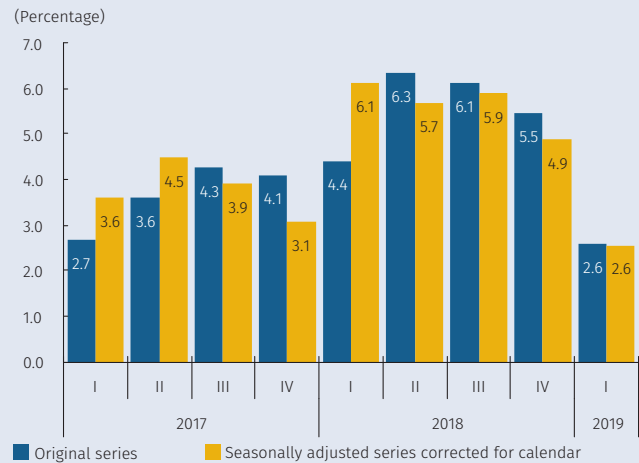
According to the figures published by DANE, government consumption rose 2.6% annually during the first quarter of 2019, both in the original series and in the seasonally adjusted series corrected for calendar effects. This is the lowest annual growth in this expense during a quarter in the last two years and is less than the amount registered in all of 2018 (5.6%) (Chart B1.1). In this box, the authors will argue why government consumption is expected to perform better during the remainder of 2019, particularly during the second half of the year.

Government consumption accounts for about 15% of gross domestic product (GDP) and its momentum in recent years explained nearly 24% of all economic growth (Chart B1.2). Due to its high share of GDP and its relevance in macroeconomic analysis, it is important to understand how this type of expenditure is measured and the variables that could determine how it is expected to perform in the short term. In terms of the national accounts, government consumption mainly reflects wage remuneration, intermediate consumption and fixed capital consumption on the part of the national government at the central level (CNG in Spanish) and the departmental and municipal governments.

The low growth in government consumption was consistent with the momentum in general budget performance at the national level during 2019. By the end of the first quarter, that performance (22%) was 13 percentage points (pp) below the average for the last five years (35%). At the end of June, it was still at historically low levels (38% versus 54% on average between 2014 and 2018) (Chart B1.3). In turn, this coincided with a significant increase in the national government's deposits with *Banco de la República* during the year, which reached a maximum of COP 39.5 trillion by the end of June (Chart B1.4).

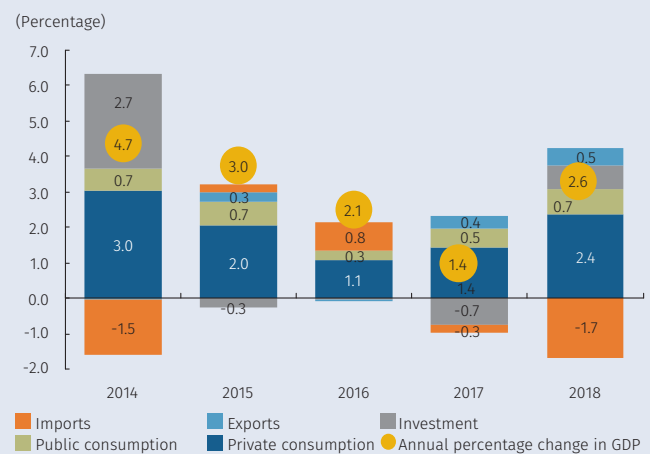
* The authors work with the Public Sector Division at *Banco de la República* as a senior advisor and lead professional, in that order. Their opinions imply no commitment whatsoever on the part of *Banco de la República* or its Board of Directors.

Graph B1.1
Annual Growth in Government Consumption



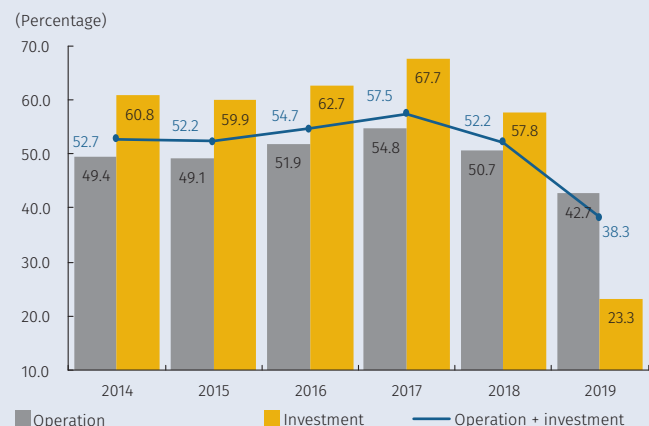
Source: DANE.

Graph B1.2
Contributions to GDP Growth



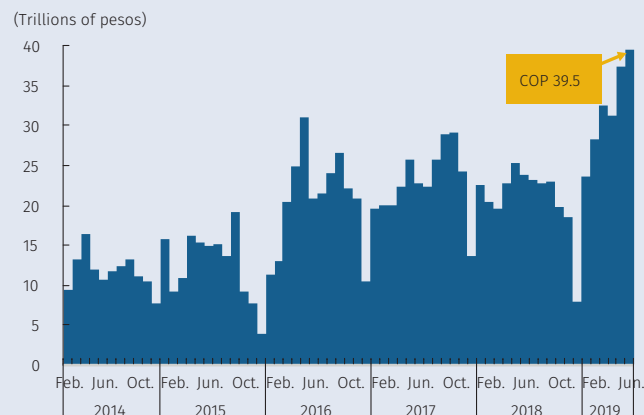
Source: DANE.

Graph B1.3
National Budget Performance during 2019 up to June
(Obligations as a percentage of the initial appropriation)



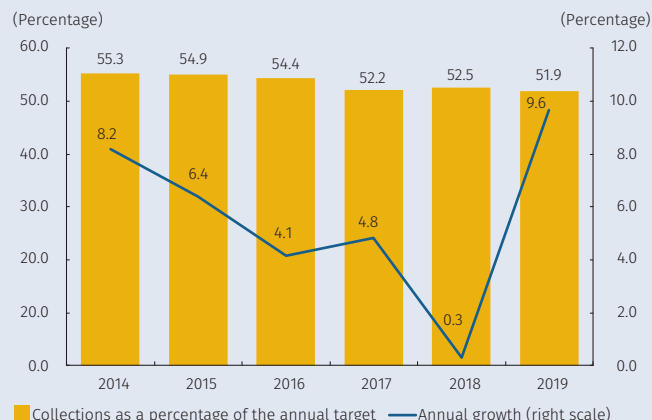
Source: Ministry of Finance

Graph B1.4
National Treasury Deposits with *Banco de la República*.



Source: Ministry of Finance

Graph B1.5
Accumulated Tax Collections by June



Source: DIAN.

The figures on budget performance up to June suggest the growth in government consumption during the second quarter of the year would have remained relatively low with respect to previous years. However, tax collections, which are the main component of CNG revenue (86%), have performed well. At the end of June, accumulated collections were up by 9.6% compared to the same period the year before, and compliance with the goal for all of 2019 was 52%: COP 157 trillion (Chart B1.5), as opposed to COP 15.3 trillion in collections for 2018. If the good dynamism in CNG revenue continues, budget performance could accelerate during the second half of the year, subject to meeting the fiscal deficit target of 2.4% of GDP for 2019. This would contribute to better government consumption in the last six months of the year. Moreover, this is the final year for the country’s territorial administrations. Historically, they have been characterized by higher budget performance during this period than in the first three years of their mandate. Accordingly, the forecast for growth in government consumption is between 3.3% and 3.6% for 2019 as a whole.

There are two main reasons for expecting a slowdown in government consumption during 2020. To begin with, it will be the first year for regional and local administrations, a time when their budget performance is usually low. Secondly, the draft national budget for 2020 suggests a cut compared to the one approved for 2019.¹

¹ At the time this section was finalized for publication, the draft of the general national budget (GNB) for 2020 was still not known. It was presented to the Colombian Congress on July 29, with an increase compared to the 2019 national budget. However, the potential risks that the national government faces in terms of acquiring the revenue needed to finance the GNB could materialize in low levels of performance that would contribute to a slowdown in government consumption during 2020.

02

The Current Economic Situation

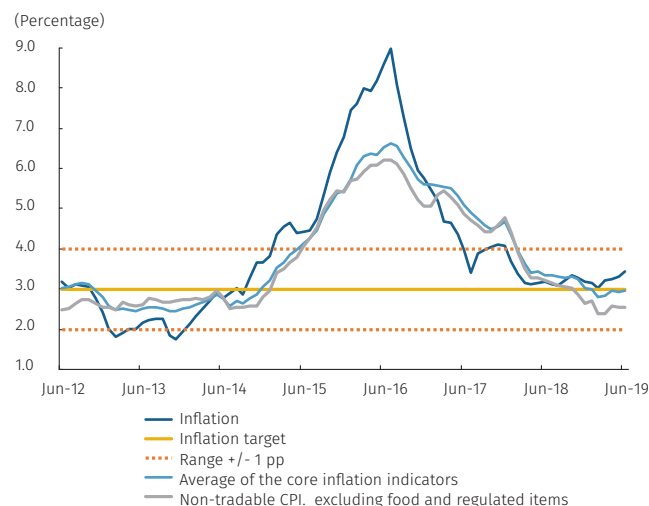
2.1 Behavior of Inflation and Prices

During the second quarter of 2019, consumer inflation remained at levels near the target, but with an upward trend that was more pronounced than what the technical staff had expected. Annual inflation was 3.43% in June. The upward pressures observed during the last three months originated mainly with food prices and, to a lesser extent, with tradables. These baskets were subject to initially transitory supply shocks that were not contemplated fully in previous editions of this report.

In recent months, core inflation remained at levels slightly below 3.0%, exhibiting an upward but moderate trend. The average of the four core inflation indicators monitored by *Banco de la República* came to 2.96% in June, representing an increase compared to the March figure (2.82%). The CPI excluding food and regulated items increased from 2.38% in March to 2.54% in June, largely due to the behavior of the tradable segment (Chart 2.1).

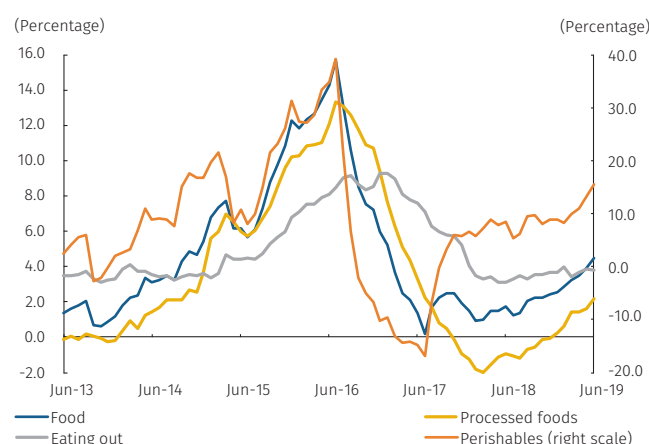
Besides the normal agricultural cycle, the acceleration in food prices (from 2.43% in December to 4.46% in June) is explained by effects associated with *El Niño* weather, higher indirect taxes and highway closures (Chart 2.2). The latest bout of *El Niño* weather, despite being classified as weak or moderate, would have had a significant (and higher than expected) impact on the prices of perishables and meats, particularly in the cities on the Caribbean coast of Colombia. In addition, the CPI for processed foods (the annual variation in

Graph 2.1
Consumer Price Index (CPI)
(Annual change)



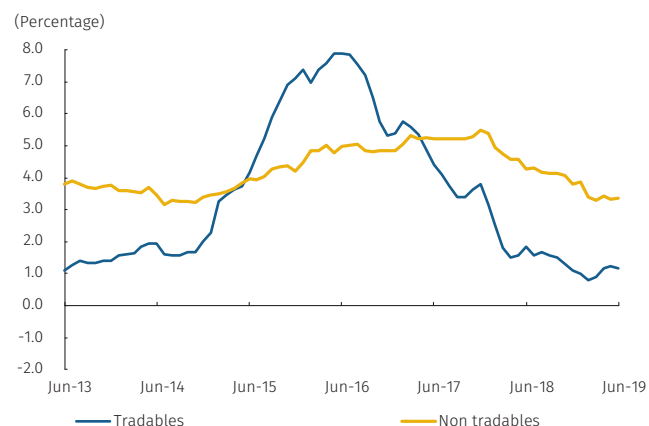
Sources: DANE and Banco de la República.

Graph 2.2
Food CPI, by Groups
(Annual change)



Sources: DANE; calculations by Banco de la República.

Graph 2.3
Tradable and Non-tradable CPI, excluding Food and Regulated Items
(Annual change)



Source: DANE; calculations by Banco de la República.

which went from -0.08% in December to 2.18% in June) has been pressured upwards by the multi-phase tax contemplated in the Financing Act, which affected the soft drink prices during the year (4.65%). Strikes by indigenous communities also caused food supply problems in the southern part of the country during the first quarter of the year, prompting prices to rise temporarily. More recently, the constant shutdowns plaguing the Villavicencio-Bogotá highway would be starting to exert upward pressure on prices for perishable foods in both cities.

The tradable CPI registered increases above what was anticipated in the last three months.

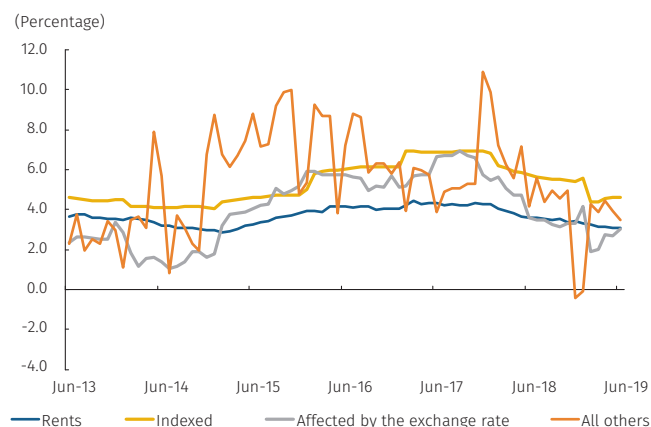
The annual variation in tradables went from 0.90% in March to 1.17% in June (Chart 2.3). The hike in the ad valorem tax on alcoholic beverages, the magnitude of which was underestimated in the previous edition of this report, would explain part of this behavior and the forecast error. That tax, which took effect on January 1 of this year, raised the price of alcoholic beverages by 7.96% during the year to June, which would have contributed 24 basis points (bp) to the 141 bp increase in the tradable CPI since January. However, it is important to be aware of the fact that this is a one-time increase and its effects on annual inflation should be temporary, especially considering it is scheduled to be reversed partially as of the third quarter.² Accumulated depreciation also had an impact on the increase in tradables, but perhaps less so than expected. The pass-through of depreciation to prices for tradables, and to the consumer in general, remains low, particularly bearing in mind the rise in the exchange rate during the second quarter.

The annual variation in non-tradables has been relative stable in recent months, contributing little to the rise in headline inflation.

The annual variation in this basket came to 3.36% in June, a

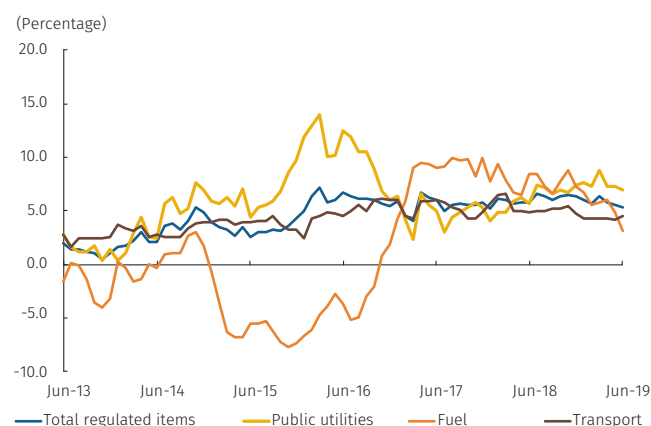
2 See the new tariff list published on 15 June 2019 together with the new methodology, which excludes hotels and restaurants (<https://www.dane.gov.co/files/investigaciones/boletines/bebidas-alcoholicas/graficas/2019-junio-Metodologia-para-el-calculo-de-PVPLVA.pdf>).

Graph 2.4
Non-tradable CPI, Excluding Food and Regulated Items
(Annual change)



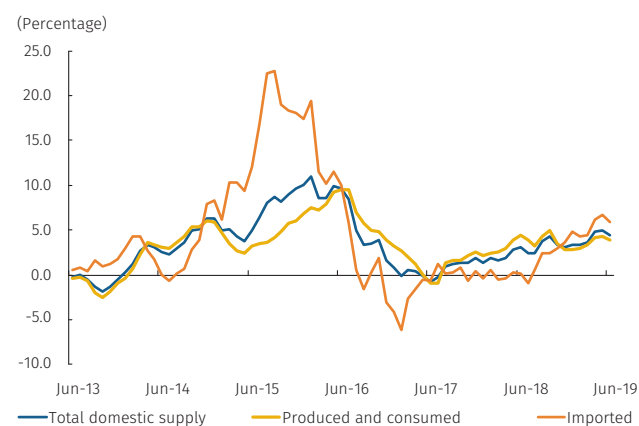
Source: DANE; calculations by Banco de la República.

Graph 2.5
Regulated CPI and Components Thereof
(Annual change)



Source: DANE; calculations by Banco de la República.

Graph 2.6
PPI by Origin
(Annual change)



Source: DANE.

level slightly above that of March (3.29%) (Chart 2.3). The presence of a negative output gap suggests demand-pulled pressures are low, which would explain the stability of this indicator throughout the year and the behavior of items such as rentals. In fact, adjustments in the latter have been declining gradually and were at 3.06% by June (Chart 2.4).

The CPI for regulated goods has slowed since March, but continues to post high increases.

The annual adjustment in this group went from 6.37% in December to 6.42% in March and 5.33% in June (Chart 2.5). The drop was in all components, with the exception of transport, which showed a downward trend but rebounded in June. Despite these declines, public utility rates (for electricity, water and gas) have maintained annual increases above 6.0% and remain the primary source of upward pressure. The hikes in energy and gas have been particularly important in the cities on the Caribbean coast and, in the case of electricity, they would be explained partly by the regional company's (Electrocaribe) added exposure to the spot price, in an environment where that price rose as a result of the higher generating costs presumed by the presence of *El Niño* weather. However, these increases would have been mitigated recently by energy imports from Ecuador and by a weakening demand for electricity. In the case of water, the rate adjustment was concentrated in the city of Medellín and is due to surcharges levied to finance environmental sanitation projects.

Consumer inflation would be facing some upward pressure due to non-labor cost increases.

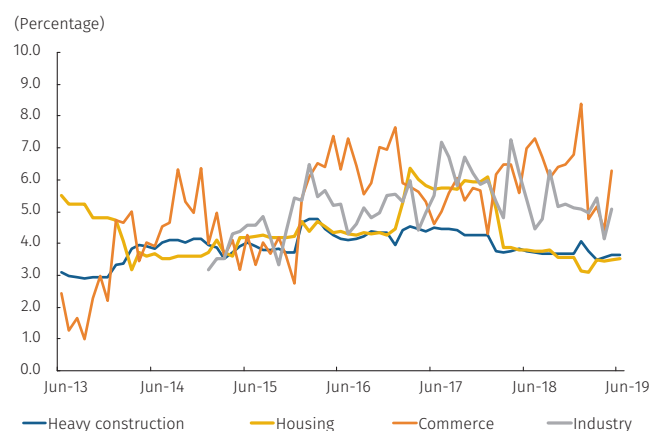
This is in line with the growing trend in the annual variation in the overall producer price index (PPI) for total domestic supply during the current year, with the rate going having gone from 3.09% in December to 4.43% in June (Chart 2.6). Bullish pressure intensified between March and May, due to peso depreciation during those months, but tended to decline in June. Another source of upward pressure has been the price of agricultural products, which were affected by *El Niño* weather, highway closures and a low base

of comparison. The annual variation in the PPI for this sector rose from 4.90% in March to 11.09% in June.

Labor costs have not brought significant upward pressures to bear on consumer prices in recent months. The 6.0% adjustment in the minimum wage this year would have had an impact on the price hikes for some non-tradable services, such as education and housing services, placing them above 4.4%. However, market wages continue to adjust at levels close to or lower than those observed last December. Accordingly, they are expected to be compatible with the 3.0% target, especially when taking into account the possible gains in productivity. With the figures at April-May, the average annual adjustment in industrial wages (4.6%) and those of commerce (5.3%) increased, although they are still at levels near to those observed at the end of last year.

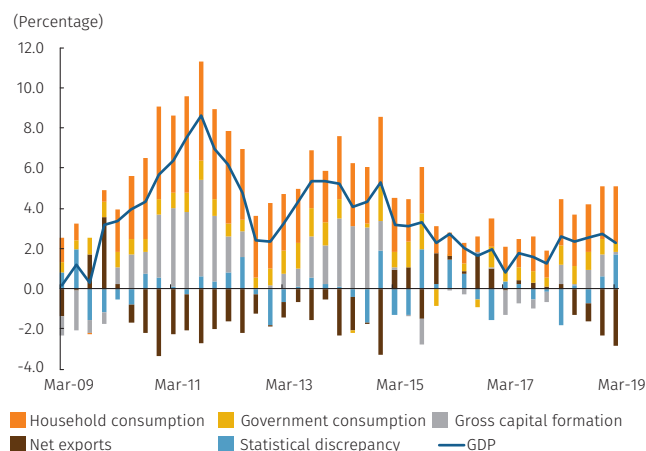
On the other hand, considering the figures at June, the adjustment in home building wages (3.6%) and those in heavy construction (3.5%) remained stable (Chart 2.7). This context, which is favorable for inflation, is expected to continue throughout the remainder of the year, since the non-accelerating rate of inflation (Nairu) estimated for 2019 would be consistently below the expected urban unemployment rate.

Graph 2.7
Nominal wages
(Annual percentage change)



Source: DANE; calculations by Banco de la República.

Graph 2.8
GDP Growth: Contribution with Respect to Expenditure^{a/}
(Annual change, percentage points)



a/ Seasonally calendar adjusted series corrected for calendar effects.
Source: DANE; calculations by Banco de la República.

2.2 Growth and Domestic Demand

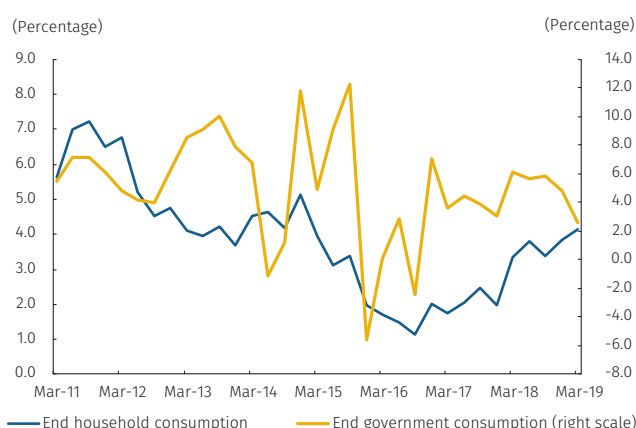
2.2.1 GDP with Respect to Expenditure

In the first quarter of 2019, the Colombian economy slowed and grew less than the technical staff anticipated. According to the seasonally adjusted figures published by the National Bureau of Statistics (DANE), which were corrected for calendar effects, GDP rose 2.3% annually during that period (Chart 2.8), which is less than the 3.2% forecast in the previous *Inflation Report*. This behavior meant zero growth between quarters. In its original series, GDP registered a 2.8% increase (as opposed to 2.7% in the fourth quarter of 2018). During those months, it was propelled by private consumption and investment in machinery and equipment, but was affected by negative shocks to other components of domestic demand that were not anticipated. Net exports contributed adversely to GDP growth.

The results with regard to spending indicate a slowdown in domestic demand during the first quarter. This seasonally-adjusted aggregate series shows a 2.7% increase during the first quarter of 2019, which is below the 4.1% observed towards the end of last year and the 3.9% for the aggregate in 2018.

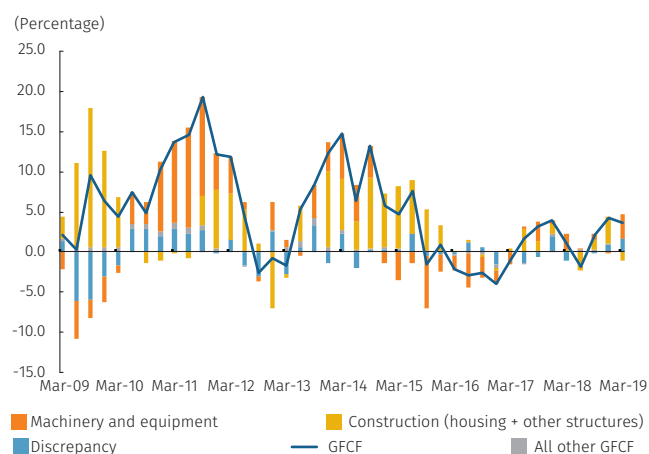
The negative shocks during the first quarter struck investment in construction (both housing and other buildings and structures, including civil works) and government consumption. Both components posted quarterly setbacks. In the first case, the largest contribution to the decline was in the residential line, probably owing to housing other than low-income units (non-LIH). In the second, the outcome would have been due to the time lag in salary adjustments in the public sector and less government spending at both national and local levels (Chart 2.9).

Graph 2.9
Spending on End Household and General Government Consumption^{a/}



a/ Seasonally adjusted series corrected for calendar effects
Source: DANE; calculations by Banco de la República.

Graph 2.10
Increase in Gross Fixed Capital Formation (GFCF): Contribution from Components Thereof^{a/}
(Annual change)



a/ Seasonally adjusted series corrected for calendar effects
Source: DANE; calculations by Banco de la República.

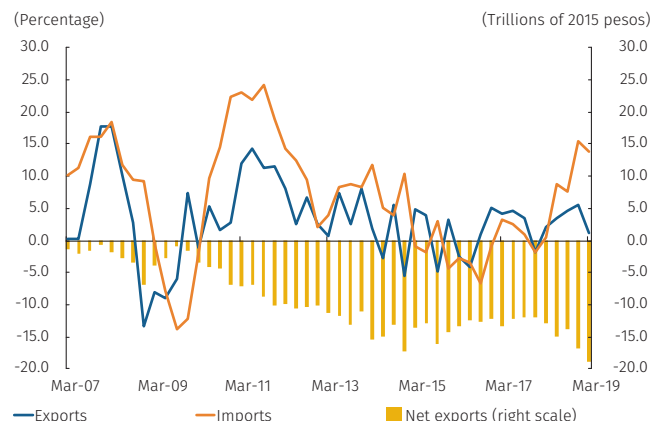
Household consumption exhibited better growth than in previous quarters and exceeded expectations (Graph 2.9). All the components of private consumption expanded in annual terms,

with services being the major contributor to growth. This occurred in a context where household spending capacity would have benefited from broad availability of credit and the trend in remittances. In fact, the year to date has seen considerable household demand for resources from the financial system, as indicated by the consumer portfolio figures. In the first quarter, this aggregate grew 9.8% annually in nominal terms. The second quarter saw this trend continue, with an annual expansion of 11.1%. When deflated with the non-food CPI, important momentum is also observed; namely, real annual growth in the consumer portfolio for the first and second quarters was 6.4% and 7.5%, in that order. The situation with remittances was similar. In dollars, their annual increase came to 9.5% during the first quarter, which was confirmed with the records in April (13.2%).

Investment in machinery and equipment saw significant growth in the first quarter of the year.

This subcomponent of gross capital formation expanded by 9.8% compared to the same period in 2018 (Chart 2.10). The seasonally adjusted series showed levels that had not been registered since 2014, a period prior to the shock to terms of trade.

Graph 2.11
Exports, Imports and the Trade Balance^{a/}
(Annual change and trillions of 2015 pesos)

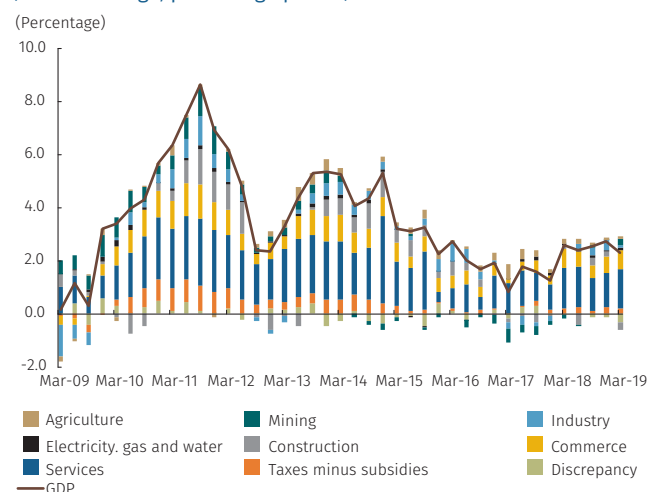


a/ Seasonally adjusted series corrected for calendar effects
Source: DANE; calculations by Banco de la República.

Exports were sluggish and did not live up to expectations. The annual increase in this GDP item was 1.1% in the first quarter of 2019, contrasting with the good performance recorded during the second half of last year (Chart 2.11). Part of this slowdown would have been the result of several supply shocks that would have limited possibilities for expanding exports of commodities, particularly coal.

During the first quarter, imports increased at annual double-digit rates (Graph 2.11). This performance, in keeping with what was observed in the case of intensive domestic demand for goods from abroad, was supported primarily by the momentum in purchases of capital goods for industry and transport equipment, as well as consumer durables.

Graph 2.12
GDP Growth: Contributions on the Sector Side^{a/}
(Annual change, percentage points)



a/ Seasonally adjusted series corrected for calendar effects
Source: DANE; calculations by Banco de la República.

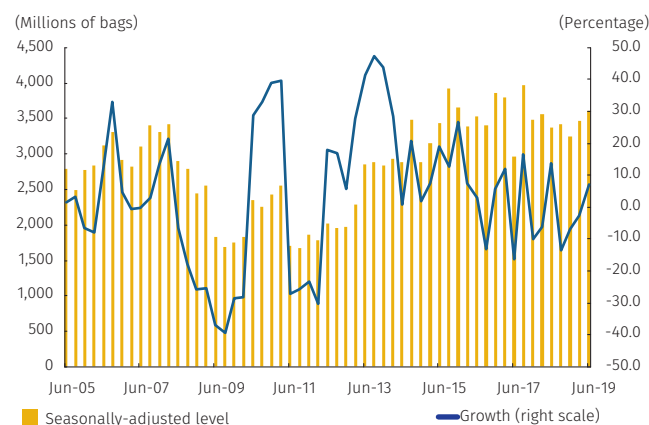
2.2.2 GDP on the Supply Side and Sector Indicators

The sectors posting the largest annual increases during the first quarter of 2019 were financial and insurance activities, along with mining. They registered 5.5% and 4.9% growth, respectively. The sector that contributed the most to annual growth during the same period was commerce, transport and accommodation, accounting for about one third of the total increase in the economy. In contrast, construction registered a sizeable annual setback (-4.5%) (Chart 2.12).

The favorable performance in the sector that includes public administration and defense, education and health also was a highlight in the first quarter. This group expanded 4.0% annually, driven mostly by the health subsector. However, the sector as a whole declined in quarterly terms, largely because of the drop in the public administration and defense subsector.

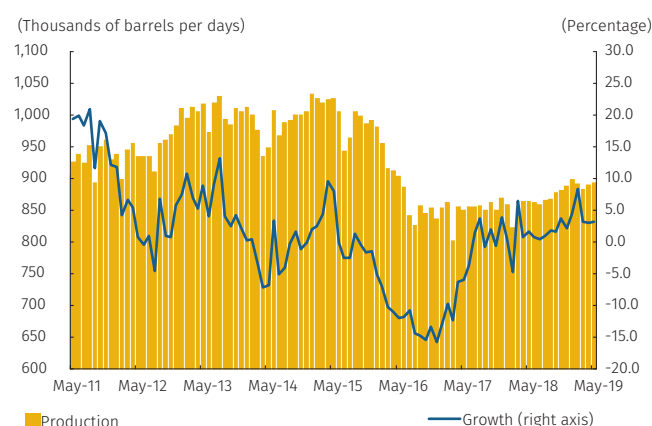
The agricultural sector posted low annual growth during the first quarter of the year, similar to what was observed the previous quarter. The 1.2% variation in the sector was due to the increase in livestock, which offset zero growth in crops. Coffee production in the second quarter points to better performance in this subsector (Chart 2.13). Mining, for its part, registered an important acceleration, mainly due to more annual growth in oil production and less of a decline in coal. During the two months from April to May, crude oil production

Graph 2.13
Coffee Production
(Quarterly and annual growth)



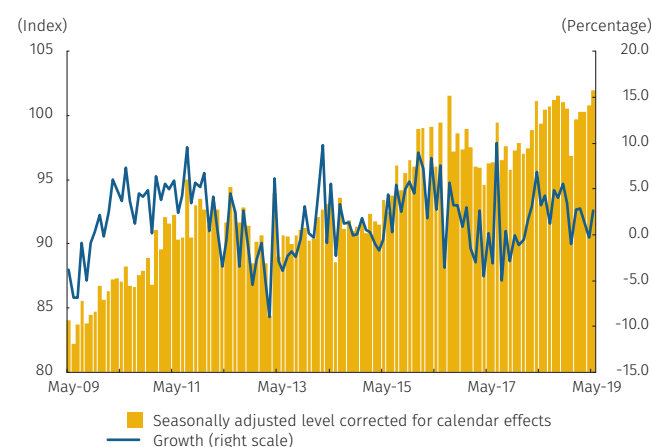
Source: Federación Nacional de Cafeteros; calculations by Banco de la República.

Graph 2.14
Oil Production
(Monthly and annual growth)



Source: ANH; calculations by Banco de la República.

Graph 2.15
Total Real Industrial Production
(Annual growth)



Source: DANE; calculations by Banco de la República.

increased in the margin, but registered less annual growth than in the first quarter (Chart 2.14).

GDP in the manufacturing industry slowed during first quarter, when the sector registered 1.0% annual growth. Additionally, it declined in quarterly terms, mainly because of setbacks in oil refining and the manufacture of machinery and equipment. When excluding refining, the other industrial activities expanded by 1.5%. Industrial production figures for April and May, from the *DANE Monthly Manufacturing Survey*, point to performance similar to what was observed in the first quarter (Chart 2.15).

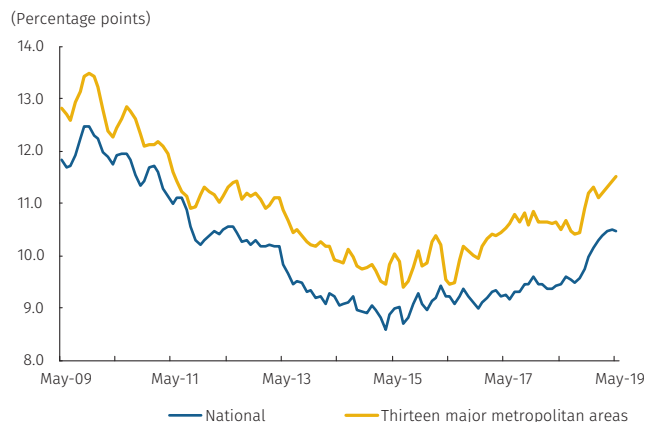
GDP in construction registered an important annual and quarterly decline, largely because of building construction. This line experienced an annual variation of -8.8% in the first quarter. Although the construction of civil works registered annual growth (4.7%), it was less so than in the quarter before.

2.3 The Labor Market

The latest employment figures show the labor market remains weak, as anticipated in past reports. The unemployment rate (UR) nationwide and for the thirteen major metropolitan areas was still relatively high. As of May 2019, the UR was higher than the year before in both these geographic domains, but was maintained, with seasonally adjusted figures, at levels similar to those of recent months (Chart 2.16). The annual increase in the urban UR is explained mainly by the drop in the employment rate (ER). The recent momentum in the global participation rate (GPR) has helped to mitigate the increase in the UR, seeing as it has registered annual declines, although lower than those in the ER.

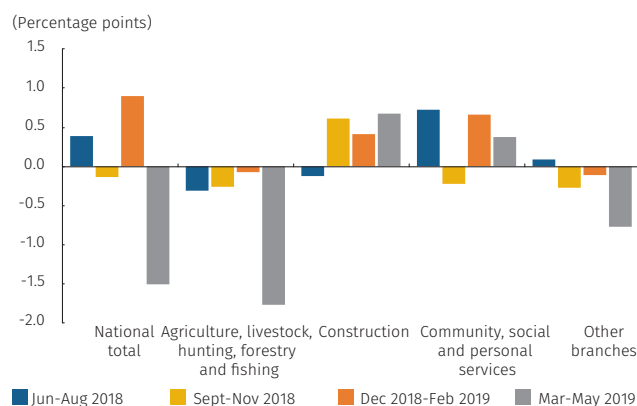
During the March-May period, the number of employed persons decreased slightly and agriculture was the economic sector that contributed most in that respect. In terms of both the national total and the thirteen major metropolitan areas, the number of employed persons decreased, which explains the lower ER in those

Graph 2.16
Unemployment rate
(Seasonally-adjusted moving quarter)



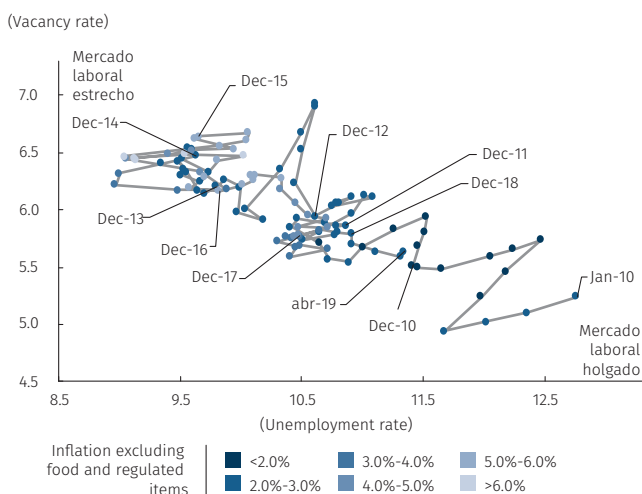
Source: DANE (GEIH).

Graph 2.17
Annual Growth in Employment by Branches
(National total)
(Contribution in percentage points to the annual change)



Source: DANE (GEIH); calculations by Banco de la República.

Graph 2.18
Beveridge Curve for the Seven Major Cities



Note: Seasonally adjusted series. Moving quarter
The vacancy rate estimated with the hiring methodology of the GEIH is the one used.
Source: DANE (GEIH) and Banco de la República.

domains. During this period, agriculture was the sector responsible for the largest negative influence on job creation nationwide, contributing -1.8 pp to the annual variation of -1.5% in the number of employed persons. The adverse performance of agricultural employment has been concentrated in the Eastern and Pacific regions of the country, and in temporary agricultural crops other than cereals, vegetables and tobacco. On the other hand, construction was the sector with the greatest positive contribution to job creation nationwide and in the urban areas, although its high growth rate is influenced by a low base of comparison last year (Chart 2.17).

As for the quality of employment in urban areas, wage earners and workers in the formal sector, who represent the highest quality employment, remained stable at levels similar to those observed the year before, while the lower quality categories, represented by non-wage earners and workers in the informal sector, declined. Although the annual increase in those employed in urban areas fell slightly during the March-May quarter (-0.9%), the better job-quality categories ceased to grow and remained stable at levels similar to those of the year before. In this context, skilled salaried employment rose moderately, while the number of unskilled wage earners declined. On the other hand, there were annual reductions in the lowest job-quality categories: -2.0% for informal workers and -1.8% for non-wage earners.

The information at hand points to a significant surplus of manpower in the labor market in relation to demand (a loose market). Accordingly, in this case the labor market does not constitute a source of inflationary pressure. The labor market narrowness indicator, defined as the ratio of vacancies to the number of unemployed, remains on a downward trend, suggesting an increasingly loose labor market. When these data are placed on the Beveridge curve, in which the vacancy rate is contrast with the unemployment rate, it is evident the labor market so far this year is at a point where it would not generate pressure on the inflation (Chart 2.18)

2.4 The Monetary and Financial Market

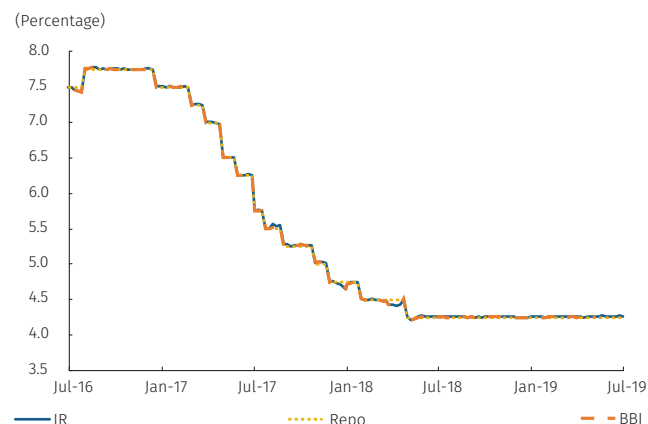
Money market interest rates have remained stable and near the policy rate (Chart 2.19). In the first half of the year, the interbank rate (IR) and the overnight banking benchmark indicator (BBI) stayed close to the policy rate, averaging 4.25% and 4.26%, respectively. BBI interest rates at one, three and six months were relatively constant during the second quarter of the year, although reductions were observed towards the end of June. Accordingly, money market conditions remain favorable and exhibit no significant pressure on the cost of these funding sources.

Interest rates on loans are still low in real terms (Chart 2.20). During the first five months of the year, real interest rates on household lending (consumer and mortgage loans) showed no definite trend and were below their historical averages. Real commercial interest rates continued at low levels during the same period. This was the result of a downward trend up to the end of 2018 in interest rates on preferential and ordinary loans.

There is still good momentum in the consumer loan portfolio, although the commercial portfolio remains weak (Chart 2.21). Real household lending has grown during the year at rates close to 7.4%, higher than the rate of growth in output. For the most part, this momentum is due to the acceleration in consumer lending. The commercial portfolio, on the other hand, has not expanded in real terms, continuing the weak momentum registered during the last two years. When other sources of business financing are included, particularly bond issues and foreign direct borrowing, growth in real terms is positive but still less than the country's economic activity.

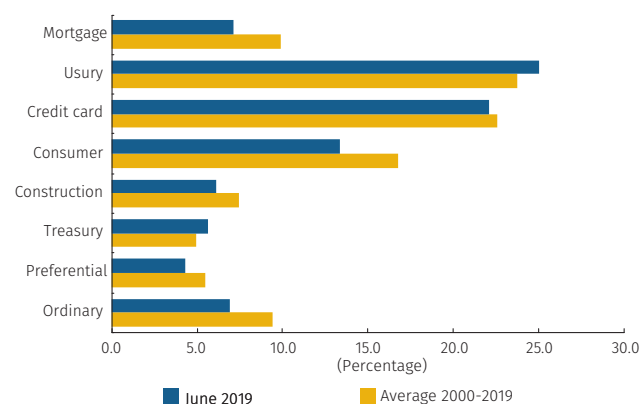
Currently, there are several supply elements that would favor commercial lending throughout the remainder of the year. These include low commercial interest rates, the slowdown in the overdue portfolio, and the high levels of coverage and adequate solvency indicators. In

Graph 2.19
Policy Interest Rate, the IR and the BBI^{a/}
(Weekly data)



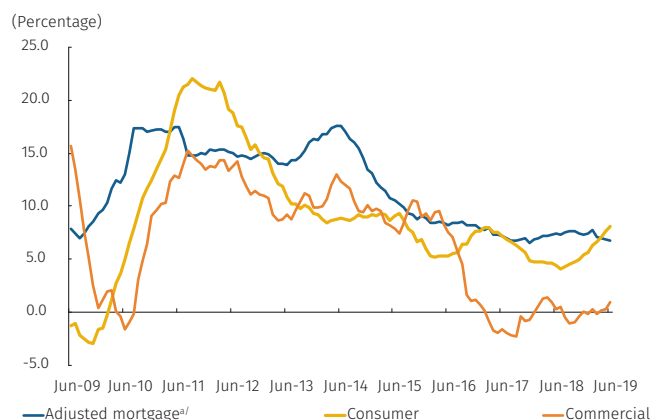
a/ IB: interbank rate; BBI: banking benchmark indicator; repo: policy rate.
Source: Office of the Financial Superintendent and Banco de la República.

Graph 2.20
Real Interest Rates on Bank Loans in Domestic Currency
(Non-food CPI deflated)



Source: Office of the Financial Superintendent and DANE; calculations by Banco de la República.

Graph 2.21
Annual Growth in the Real Gross Portfolio in Domestic Currency
(Non-food CPI deflated)



a/ Bank loan portfolio plus securitizations
Source: Office of the Financial Superintendent and DANE; calculations by Banco de la República.

addition, the credit and expectation surveys show agents perceive a good availability of loans, with a tendency to improve, and a willingness on the part of financial institutions to increase their lending.

Box 2 Recent Performance of GDP in the Construction Sector and Prospects for 2019

Juan Pablo Cote
Sergio Restrepo*

The figures on gross domestic product (GDP) in the first quarter of 2019 (seasonally adjusted and corrected for calendar effects) show construction, on the supply side, was down 4.5% annually and 4.0% quarterly. This was the second consecutive quarterly decline in construction, since it also registered a slight drop during the final quarter of 2018 (Chart B2.1).

In terms of components, most of the decline was due to building construction,¹ which fell 8.8% annually and 9.6% quarterly in the early months of the year. Civil works construction rose 4.7% annually, but contracted 5.3% quarterly, after posting a recovery from the second to the fourth quarter of 2018.

A look at the subsectors shows the quarterly drop in building construction was concentrated mainly in the residential branch. According to building census conducted by the National Bureau of Statistics (DANE), with figures up to the first quarter of the year, the reduction in structure completions between quarters in the twenty territories covered came to 13.2%. Nearly two-thirds of that decline pertains to buildings for residential use (with a quarterly variation of -11.8%); the other third corresponds to buildings for non-residential use (Chart B2.2).

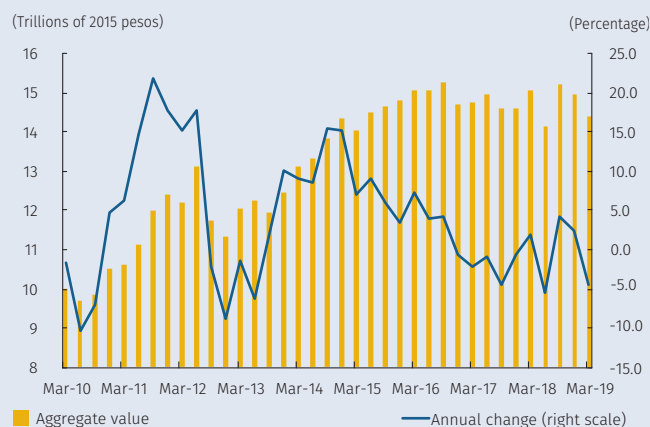
As for the construction of civil works, the DANE indicator of investment in civil works (Spanish acronym: IIOC) suggests the quarterly drop in the subsector was due to a setback

* The authors work with the Programming and Inflation Department at *Banco de la República* as a professional and expert professional, in that order. Their opinions imply no commitment whatsoever on the part of *Banco de la República* or its Board of Directors.

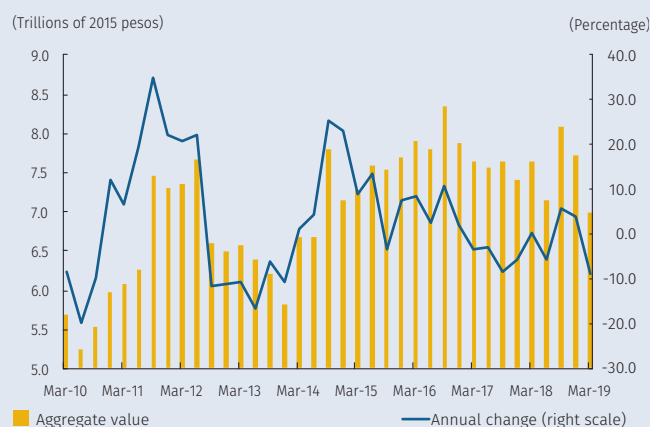
1 Including homes (houses and apartments) and non-residential buildings (for offices, commerce, warehouses, education, hotels, hospitals, public administration and other uses).

Graph B2.1
Aggregate Value of Construction and its Components
(Seasonally adjusted and corrected for calendar effects)

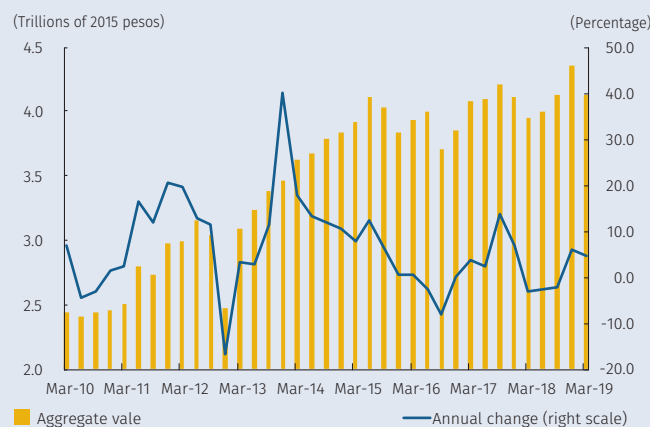
A. Construction



B. Residential and non-residential building construction

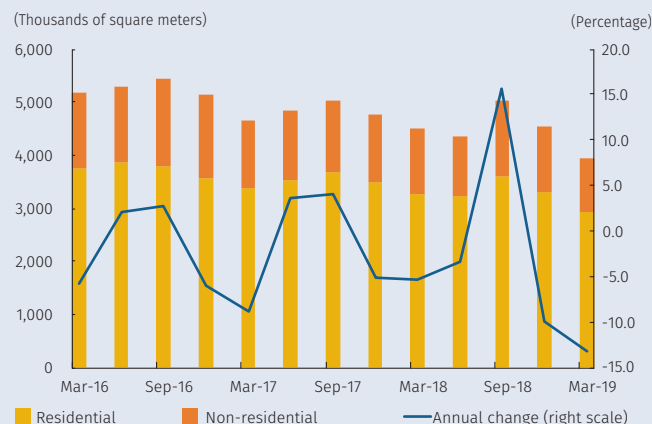


C. Construction of highways, railways, public utility projects and other civil engineering works



Source: DANE; calculations by *Banco de la República*.

Graph B2.2
Structure Completions, According to the Building Census



Source: DANE; calculations by Banco de la República.

in the line of construction pertaining to railways, airstrips and mass transit systems. It was down 20% annually at the start of the year in its original series.

On the demand side, this performance also was reflected in less investment in construction. During the first quarter, investment in housing registered an annual setback of 7.9% and a quarterly decline of 8.3%. On the other hand, although investment in other structures rose 1.7% annually, it dropped by 5.3% between quarters.

1. Prospects for GDP in the Construction Sector during 2019

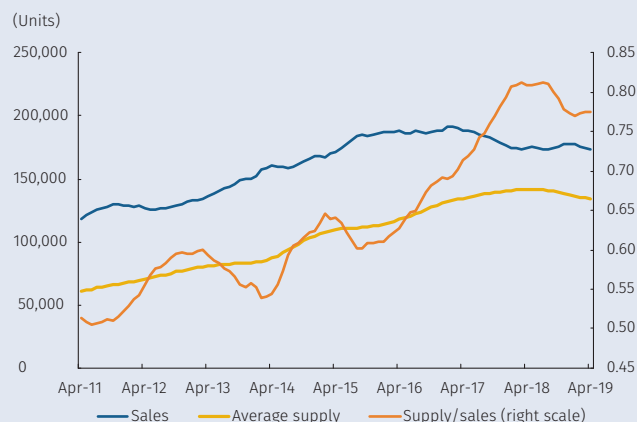
There is a great deal of uncertainty about the performance of construction in the coming quarters, mainly because its recent behavior shows no clear trend. However, the forecast developed by the technical staff at Banco de la República anticipates part the shock observed in construction at the beginning of the year will be reversed during the remainder of 2019. The reason is that, despite indicators of weaknesses in the sector, other data allow us to expect some recovery.

The first group of indicators includes housing sales and supply.² In the twelve months up to April, these indicators declined by 0.8% and 5.0% annually, in that order (Chart B2.3). Judging by low-income housing (LIH) and non-LIH, the poor sales performance and the drop in supply occurred primarily in this last segment.

Moreover, the performance of building permits, which reflected lagging momentum that seems to have some link to the sluggishness in GDP for buildings, also showed signs of

² The supply at any point in time is equal to the available units of the previous period, plus the balance between the new units placed on the market and the units sold during that lapse of time.

Graph B2.3
Home Sales (12 month aggregate) and Supply (12-month moving average)

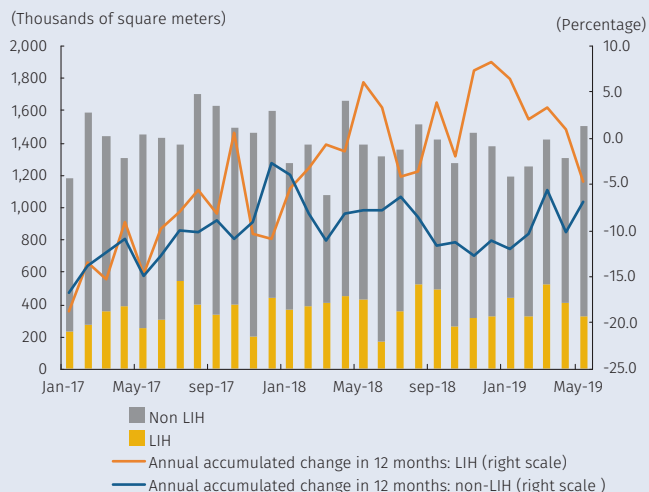


Source: Camacol, calculations by Banco de la República.

weakness in recent months. Specifically, the area licensed for home construction³ fell 1.8% annually between January and May of this year, although it did show a slight trend towards recovery in the margin (Chart B2.4). The main annual decline in this segment was in non-low income housing. Licenses for non-residential construction dropped 9.6% annually during that same period, with the area licensed for warehouses registering the largest reduction (-50.1%).

However, in contrast to these indicators, other figures for construction denote more favorable performance. One example is employment in the construction sector. Its seasonally-adjusted series corrected for calendar effects has been relatively stable (as per the trend) since the end of 2018. When construction employment is broken down into civil and related works, one sees this momentum has been

Graph B2.4
Area Approved for Housing and Annual Accumulated Change in 12 Months



Source: DANE, calculations by Banco de la República.

³ As reported for 302 municipalities in the country's 32 departments.

connected mainly to construction employment without civil works, a proxy for that meant for building construction (Chart B2.5).

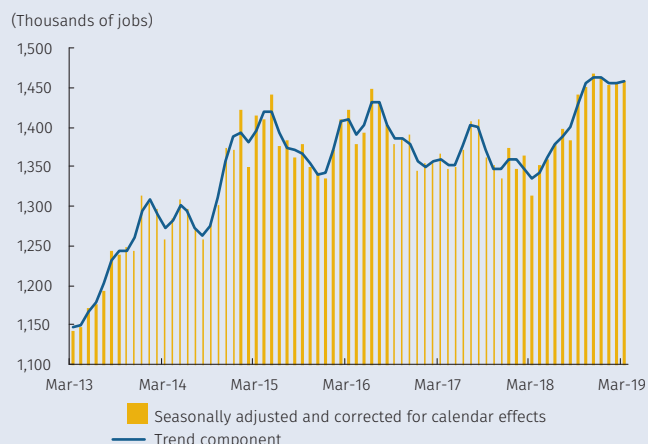
On the other hand, the Fedesarrollo Consumer Confidence Index (ICC in Spanish) shows that consumer intention to purchase a home has been somewhat stable since 2017. Furthermore, the recent past has seen no deterioration in this balance, in keeping with the results for housing construction (Chart B2.6). Therefore, we can expect some momentum in housing demand.

According to *Banco de la República's* latest *Report on the Credit Situation in Colombia*, there was an increase in the proportion of banks that lowered their home loan requirements in the last three months, and none said they had increased them. This trend is expected to continue for the next three months and would be accompanied by historically low real interest rates on mortgages, all of which could stimulate the home building sector.

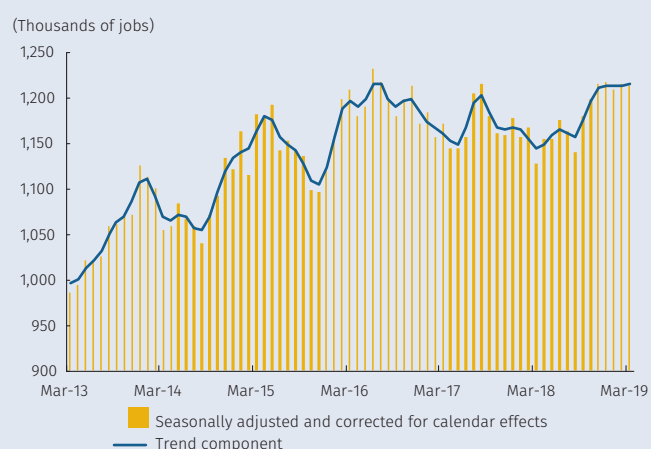
Finally, the coming quarters are expected to see home construction benefit from a number of initiatives undertaken by the national government to stimulate demand. These consist of granting new resources to boost the purchase of low-income housing (LIH) and raising the mortgage loan limit from 70% to 90% of the value of non-LIH. Coupled with historically low real growth in prices for new and existing homes (Chart B2.7), together with somewhat less inventory turnover up to June 2019,⁴ this suggests current weakness but also signals the possibility of a recovery in the coming quarters. The construction of civil works would continue to recover (following the quarterly drop in the first three months of the year), backed by regional and local budget performance and by the anticipated revival in fourth-generation highway projects.

Graph B2.5
Employment in Construction: Total and Excluding Civil Works
(National total; moving quarter)

A. Total construction

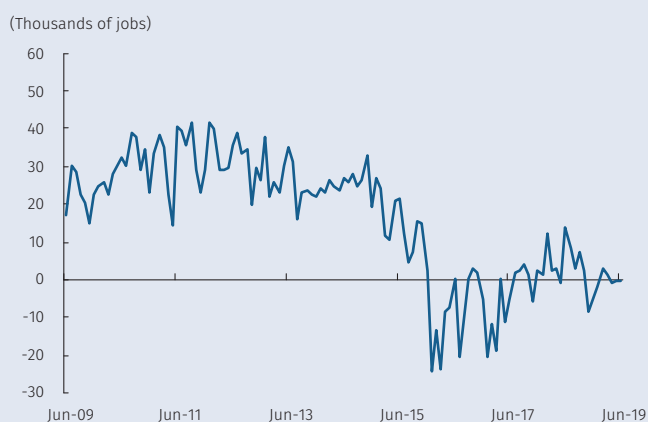


B. Construction without civil Works



Source: DANE, calculations by *Banco de la República*.

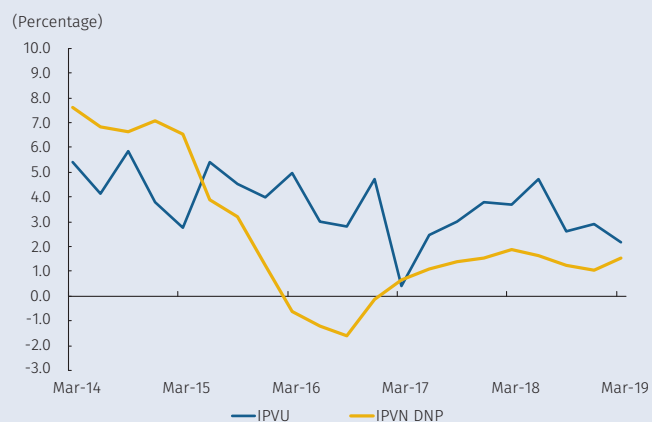
Graph B2.6
Balance of the Question Posed by the ICC and Fedesarrollo: Do you think this is a good time to purchase a home?



Source: Fedesarrollo.

⁴ This is calculated as the ratio of housing units offered monthly to the quarterly average of new homes sold. Source: *La Galería Inmobiliaria*.

Graph B2.7
New and Existing Home Price Indexes
(Annual percentage change)



Source: DNP and Banco de la República; calculations by Banco de la República.

Box 3

The Impact of Recent Migration from Venezuela on the Colombian Labor Market

José David Pulido*

In the last three years, Latin America has witnessed a migratory phenomenon unlike any in its history. According to figures compiled by the United Nations, the number of migrants from Venezuela amounted to four million people in 2019.¹ Estimates based on DANE's *Integrated Household Survey* (GEIH) show Colombia, the main receptor country, was home to approximately 1.4 million Venezuelans by March 2019. The objective of this section is to examine the possible impact of that migration on the Colombian labor market.

The literature on analysis of the impact of migration on employment and wages distinguishes between two major approaches. The first analyzes the decisions that lead people to migrate and the process whereby migrants assimilate into the destination labor market. When controlling for the observable characteristics of workers, empirical studies for different countries find that migrants enter with lower levels of employment and income than locals, but these gaps disappear as migrants stay on in the receptor country.² The second approach, which is emphasized in this section, examines the “displacement” effects migrants can generate with respect to the employment and wages of local workers. In other words, seeing as the other productive factors are immobile in the short term, economic theory indicates an exogenous increase in the labor supply

should push down workers' average wages. Given the possible existence of wage rigidities, this pressure also would result in an increase in unemployment.

There are very few empirical studies for Colombia that validate the premise of displacement caused by migration, since the phenomenon is still ongoing. However, two recent papers attempt to quantify the magnitude of these effects. For the first, the Labor Market Analysis Group (Gamla) at *Banco de la República* estimated an econometric model in which the migration rates for each region, as reported in the GEIH, are regressed on the variables of labor market of interest, and migration is instrumented to avoid endogeneity biases.³ In doing so, it found that a 1.0 pp increase in the migration rate would be associated with a 0.21 pp increase in the unemployment rate and 0.18 pp in the informality rate (Gamla, 2019). Secondly, Santamaría (2019) quantifies the impact of migration on employment and its disaggregation (formal and informal) and on wages, using a difference-in-differences strategy as an empirical method and measuring migrants by figures on migration to Colombia and by the number of Google searches for keywords Venezuelans could look for when migrating.⁴ With regard to employment, the preliminary results show the effect of migration is not statistically different from zero, but there is a reshuffling of formal to informal employment: an increase of 1 pp in the immigrant population raises informal employment by 0.2 pp. As for wages, it was found that a 1 pp of increase in the immigrant population reduces wages in the informal sector by 1.7 pp, on average, and there is no significant change in salaries in the formal sector. A drop in wages of about 1.3 pp is perceived in the aggregate.

In order to measure the labor market implications of the elasticities found for the Colombian case, two possible scenarios are considered for the anticipated path of migration. Both work with the same figures for migrants observed in the 2015 - 2018 period, obtained from estimates of the GEIH: 1,049,000 migrants in total for that period, including 819,000 of working age. In contrast, two variants are considered for future migration built on estimates based on demographic projections. In the first scenario, which is referred to as “normal migration” and considered the most likely, future migrants in the period from 2019 to 2026 would account for another 946,000 individuals, including 768,000 of working age. In the second scenario, which is called “high migration,” future migrants in the same period would come to 1,976,000 additional individuals, including 1,614,000 of working age. Figure B3.1 shows

* The author is a junior researcher with *Banco de la República's* Labor Market Analysis Group (Gamla). He wishes to thank Julio Romero, a researcher at the Cartagena branch, for his help with the demographic forecasts.

1 In recent history, the magnitude of this migration is greater than the one caused by the brutal conflict in South Sudan (2.2 million) and is second only to the Syrian migration (5.6 million). Source: UNHCR (2019).

2 See Borjas (1994) for a summary of the levels found by the leading empirical studies up to the early 1990s, and Kerr and Kerr (2011) for the findings of studies from the 1990s to the start of the current decade.

3 The instruments used include the interactions of the percentage of individuals in each region who reported in the 2005 Census as having been born in Venezuela and variables that reflect the momentum in the Venezuelan economy (Venezuelan imports and the exchange rate on the parallel market).

4 For example, searches for key words such as “Venezuelans in” or “special residency permit.”

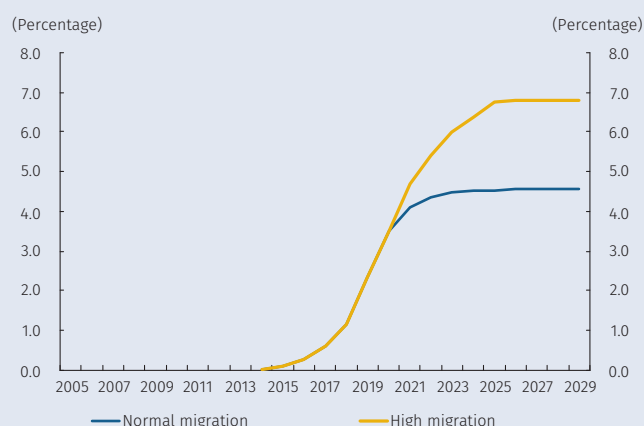
the participation of migrants of working age in the WAP and how they would modify the path of their expansion in both scenarios.

On the other hand, the economic growth estimates worked out for the next two years by the technical staff at *Banco de la República* are used to feed an unemployment rate projection using an econometric model based on the principle of Okun's law.⁵ Based on this forecast and the two migration scenarios being considered, the elasticities obtained in Gamla (2019) are used to quantify the impact of migration on the unemployment rate. The result is shown in Chart B3.2. The greatest impact of migration on the unemployment rate would have been reached at the end of 2018 and would be 0.25 pp. The average impact during 2019 would be 0.24 pp.

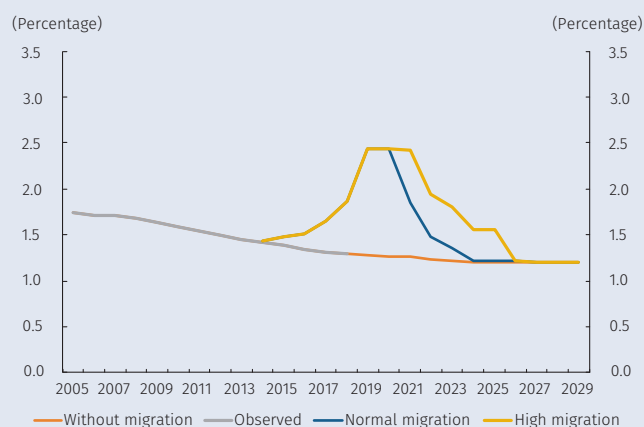
Therefore, the empirical evidence suggests that displacement does impact the Colombian labor market but to a small degree. Although these results suggest the effects of displacement are mild, on average, it is important to point out that they may be heterogeneous and accentuated in specific segments of the population. Additionally, the sizes of the elasticities found in Colombia are consistent with what the empirical literature shows with respect to studies on large-scale migrations in other countries. Despite some dispersion in the results, most of that research indicates the effects of displacement are significant but limited. For example, Kerr and Kerr (2011), in a compilation of more than 25 studies carried out from 1990 to the beginning of the current decade,⁶ found the effects in most cases are null or negative in magnitude, but very low. In a compilation that is similar but focused on studies published for the present decade that analyze forced migrations, Becker and Ferrara (2019) obtained comparable conclusions, although with a slightly greater dispersion of results.

Graph B3.1
Future Migration Scenarios

A. Migrants of working age as a percentage of the WAP

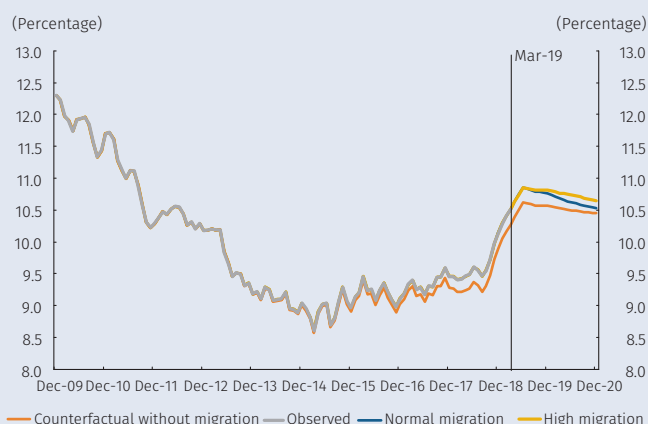


B. Annual growth in the WAP with migration



Source: DANE (GEIH), calculations by Banco de la República.

Graph B3.2
Unemployment Rate With and Without Migration



Source: DANE (GEIH), calculations by Banco de la República.

5 This model is based on the methodology presented in Flórez et al. (2018).

6 Cases of mass migration to different European countries, the United States, Israel and Australia are analyzed.

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Annex Macroeconomic Forecasts by Local and External Analysts

A summary of the latest forecasts by local and external analysis concerning the main economic variables for 2019 and 2020 is presented in this annex. At the time they were consulted, the analysts had access to data up to July 22, 2019.

1. Forecasts for 2019

On average, the local analysts expect 3.1% economic growth, which implies a decline in the average growth anticipated by analysts in the *Inflation Report* for last quarter (3.2%). Similarly, the external analysts that were consulted forecast 3.0% average GDP growth, less than the figure in the *Inflation Report* for last quarter (3.2%).

As for prices, the local analysts anticipate 3.5% inflation by the end of the year, higher than the forecast in the previous report (3.3%). The external analysts, for their part, expect inflation to be

Cuadro A1
Proyecciones para 2019

	Crecimiento del PIB real (porcentaje)	Inflación IPC	Tasa de cambio nominal fin de	DTF nominal (porcentaje)	Déficit fiscal (porcentaje del PIB)	Tasa de desempleo en las trece ciudades (porcentaje)
Analistas locales						
Alianza Valores ^{a/}	3,2	3,8	3.300	4,6	2,7	10,0
ANIF ^{b/}	3,3	3,5	n.d.	4,9	2,0	10,6
Banco de Bogotá ^{a/}	3,0	3,4	3.200	4,5	2,4	10,5
Bancolombia ^{a/}	2,9	3,5	3.180	4,7	2,7	11,1
BBVA Colombia ^{a/}	3,0	3,3	3.186	4,5	2,4	11,0
BTG Pactual ^{a/}	2,8	3,4	3.180	4,5	3,0	n. d.
Corficolombiana ^{b/}	3,2	3,4	3.130	4,5	1,8	n. d.
Corredores Davivienda ^{a/, c/}	3,1	3,6	3.200	4,5	2,5	n. d.
Credicorp Capital ^{b/, d/}	3,3	3,5	3.150	4,7	2,1	11,2
Davivienda ^{a/}	3,1	3,6	3.200	4,5	2,5	n. d.
Fedesarrollo	3,3	3,2	n. d.	n. d.	n. d.	n. d.
Itaú ^{b/, e/}	2,6	3,4	3.300	4,4	2,8	10,3
Ultraserfinco ^{a/, f/}	3,3	3,6	3.030	5,0	2,4	11,5
Promedio	3,1	3,5	3.187	4,6	2,5	10,8
Analistas externos						
Citigroup	3,1	3,3	3.182	n. d.	n. d.	n. d.
Deutsche Bank	3,2	3,4	n. d.	n. d.	n. d.	n. d.
Goldman Sachs	3,0	3,2	3.050	n. d.	n. d.	n. d.
JP Morgan	2,8	3,6	3.300	n. d.	n. d.	n. d.
Promedio	3,0	3,4	3.177	n. d.	n. d.	n. d.

a/ La proyección de déficit fiscal corresponde al del GNC.

b/ La proyección del déficit fiscal corresponde al del SPC.

c/ Antigua Corredores Asociados.

d/ Antigua Correval.

e/ Antigua Corpbanca, hasta junio de 2017.

f/ Antigua Ultrabursátiles.

n. d.: no disponible.

Source: Banco de la República (encuesta electrónica).

Cuadro A2
Proyecciones para 2020

	Crecimiento del PIB real (porcentaje)	Inflación IPC	Tasa de cambio nominal fin de
Analistas locales			
Alianza Valores	2,8	3,7	3.400
ANIF	3,5	3,4	n. d.
Banco de Bogotá	3,5	3,0	3.225
Bancolombia	3,4	3,2	3.260
BBVA Colombia	3,0	3,2	3.227
BGT Pactual	2,8	3,0	3.120
Corficolombiana	3,5	3,3	3.165
Corredores Davivienda ^{a/}	n. d.	n. d.	n.d.
Credicorp Capital ^{b/}	3,2	3,2	3.050
Davivienda	n. d.	n. d.	n. d.
Fedesarrollo	3,5	3,0	n. d.
Itaú ^{c/}	2,8	3,0	3.300
Ultraserfinco ^{d/}	3,5	3,2	2.950
Promedio	3,2	3,2	3.189
Analistas externos			
Citigroup	3,5	3,0	3.187
Deutsche Bank	3,5	3,4	n. d.
Goldman Sachs	3,5	3,0	2.900
JP Morgan	3,0	3,4	n. d.
Promedio	3,4	3,2	3.044

a/ Antiguo Corredores Asociados.

b/ Antiguo Correval.

c/ Antiguo Corpbanca, hasta junio de 2017.

d/ Antiguo Ultrabursátiles.

n. d.: no disponible.

Source: Banco de la República (encuesta electrónica).

3.4% at the end of the year. Both forecasts are slightly above the 3.0% inflation target set by the Board of Directors of *Banco de la República* (BDBR).

With respect to the exchange rate, the local analysts expect the market exchange rate (MER) to end the year at COP 3,187, on average, as opposed to COP 3,116 in the previous report. The external analysts forecast an MER close to COP 3,177 by the end of the year.

In terms of the fixed-term deposit rate (DTF), the local analysts are forecasting 4.6%, on average. They also expect the unemployment rate to be 10.8%.

2. Forecasts for 2020

For 2020, the local national analysts anticipate 3.2% economic growth, while the external analysts are projecting 3.4%. As for inflation, both the local and external analysts expect it to be 3.2%. With regard to the nominal exchange rate, the local analysts expect it to average COP 3,189 and the external analysts, COP 3,044.

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