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The Monetary Policy Report presents the Bank's technical staff's analysis of the economy and the inflationary situation and its medium and long-term outlook. Based on it, it makes a recommendation to the Board of Directors on the monetary policy stance. This report is published on the second business day following the Board of Directors' meetings in January, April, July, and October.

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At the end of 2012 annual inflation stood at 2.4%, lower than the long-term target (3%) and within the year's target range (2%-4%) (Graph A). Fourth-quarter inflation results were lower than average market expectations and also below the rates expected by Banco de la República's technical staff. The deceleration in inflation came largely from slower growth in the consumer price index (CPI) for food and regulated items.

Annual change in food CPI has been on a downward trend since October 2011, when it was at a peak for the present decade. The return of normal weather after the 2011 La Niña climate event helped to increase food supply and was thus responsible for much of the negative annual change in non-processed food. Moreover, lower international prices for some of Colombia's agricultural commodity imports were passed through to domestic prices, further helping to curb growth in food CPI. In December 2012 annual change in food CPI was 1.7%, down by 194 basis point (bp) on the previous quarter.

The fourth quarter saw lower annual change in non-food CPI and the other core-inflation measures. In December 2012 core-inflation measures averaged 2.80%, lower than the long-term target and 36bp below the September average. Slower fourth-quarter growth in regulated items stemmed from gas, energy, fuel and public transport, helped by year-on-year stable international oil prices and by the peso's appreciation. In addition, some local governments decreed unforeseen reductions in urban transport fares and other public services.

Regarding the components of the non-food CPI excluding regulated items, in December tradables rose year-on-year by 0.77% and non-tradables by 3.92%. The peso's appreciation and lower external inflationary pressures accounted for the low rise in tradable prices, while price growth in nontradables continued to be driven by housing rents, which increased at rates close to the target-range ceiling.

The above consumer-price trends, together with low inflationary pressures from demand and from labor costs, helped to reduce inflation expectations at all horizons. Both the survey of economic analysts and the estimates based on public-debt securities point to inflation expectations of less than 3%.

Inflation forecasts for 2013 have also been reduced, with a central path that is estimated to rise but stay below 3%. Food and regulated CPI is projected to accelerate at annual rates close to the long-term target. The non-tradable excluding food and regulated items should lose pace, partly because of little demand pressure and because some indexed prices would be adjusted by last year's low inflation rate. Annual growth in tradable goods prices should not vary greatly.

Regarding external demand, low global growth in the fourth quarter of 2012 was much as expected in the September Inflation Report. This weak performance has held back international trade, negatively affecting exports and industrial production all over the world, including Colombia. International oil prices have stayed high, while prices for coffee and coal have fallen. Thus, the rising trend in the terms of trade that had continued through 2011 was disrupted in 2012 and became relatively flat.

In 2013 the measures adopted by the European authorities and improvements in financial conditions have reduced the likelihood of a strong recession in the euro zone. The United States might grow less than in 2012. The emerging countries will drive the world economy once more, with increases in their gross domestic product similar to the expansion in their potential output. It is therefore likely that economic activity in countries that are Colombia's main trading partners will continue to be weak, expanding at much the same average rate as observed in 2012.

Low global growth and weak global inflationary pressures suggest that international interest rates should remain low. Colombia’s terms of trade could be somewhat lower than the 2012 average, as a result of very modest world growth. It is therefore possible that the country’s national income will continue to be sustained by high terms of trade, albeit lower than those observed last year.

Domestically, in the third quarter of 2012 Colombia’s economy was down by 0.7% on the second quarter, but up by 2.1% on a year earlier. The loss of pace was greater than expected and resulted mainly from a decline in civil works, construction and buildings. Growth in household consumption (4%) slowed as expected. Exports lost pace faster than imports.

For the fourth quarter of 2012 new information on consumer lending, retail trade and consumer confidence suggests that household spending grew somewhat more slowly than in the third quarter. There was great uncertainty about investment behavior, particularly about spending on civil works, construction and buildings. Export figures in dollars point to greater deceleration in external sales than in imports.

In November the industrial production index (IPI) fell, and the sector’s expectations deteriorated once more. Retail sales grew apace. In mining, the public-order and transportation problems that had hampered the sector in the third quarter appeared to have dissipated in late 2012, resulting in recovery in oil and coal production.

Based on the foregoing, the technical staff has revised down the GDP growth range forecast for 2012 to 3.3%-3.9%. In 2013 GDP could grow at a rate in the upper half of an estimated range of 2.5%-4.5%. Uncertainly about investment behavior in Colombia and about the size of the recession that could occur in the euro zone is accountable, in good measure, for the width of the forecast ranges.

To sum up, economic activity in the second half of 2012 slowed faster than expected, and both headline inflation and the average of the core-inflation measures ended the year at rates below 3%. For 2013, GDP is projected to grow at a rate below its potential in the first half of the year, resulting in a negative output gap. In addition, weakness in demand and the recorded deceleration in credit reduce the likelihood of any financial imbalances being created. And the context for the above is one in which inflation expectations and projections stand below 3%.

The Board of Directors of Banco de la República, having assessed the above economic setting and the balance of risks, decided to reduce the benchmark rate from 4.75% in September 2012 to 4% in January 2013 (Graph B). The Board further decided to continue the accumulation of international reserves, in a context in which there is a greater likelihood of currency mismatches than in the past, the economy is slowing, and monetary policy is expansionary. The foreign currency purchases should bring reserve indicators closer to the levels internationally regarded as the most adequate. Accordingly, the program of daily auctions for purchasing foreign currency has been extended, in order to accumulate at least US$3 billion between February and May of this year, through daily purchases of at least US$30 million. Average monthly purchases will thus be increased from US$500m to not less than US$750m under this program.