[Monetary Policy Report]

A regular meeting of the Board of Directors of Banco de la República took place in the city of Bogotá D.C. on Friday, November 27, 2015. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; José Darío Uribe Escobar, Governor of the Central Bank; and co-directors Carlos Gustavo Cano Sanz, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, Cesar Vallejo Mejia, and Juan Pablo Zárate Perdomo.

The following is a summary of the vision of the technical staff at Banco de la República on the macroeconomic situation (section 1) and an overview of the main policy discussions considered by the Board of Directors (section 2).

Further detail on the macroeconomic situation prepared by the technical staff from the Central Bank will be presented in the Inflation Report for October 2015 and in the statistical annex.

1. MACROECONOMIC CONTEXT

1. The most recent figures continue to exhibit a weak global economic activity. In the United [illegible] would have deepened, and the other large countries in Latin America grow at rates lower than those observed in previous years.
2. The probability of the FED increasing its benchmark interest rate in December rose, the [illegible] commodities lowered. The price of oil was below the expectations of the technical staff at Banco de la República, and the terms of trade continue at low levels.
3. In the third quarter, exports fell (-41.9% on a yearly basis) more than imports (-17.2% on a yearly basis) resulting in a widening of the trade deficit greater than had been forecast by the technical staff.
4. In Colombia, retail sales (except motor vehicles) for the third quarter show that household [illegible] positive dynamics, according to the indicators of production and shipment of cement. Similarly, industrial production shows a growing trend.
5. The unemployment rate remains low, although a slight reduction in the number of occupation was observed in the quarter (in the national total and in the thirteen areas). The seasonally adjusted series do not show a clear trend.
6. The information available for the fourth quarter is still scarce. On side of demand, the [illegible] in the perception of the current situation of trade. However, the six-month prospects of trade maintain a negative trend.
7. With all of the above, the technical staff maintained its forecast range for economic growth for 2015 between 2.4% and 3.4%, with 3.0% as the most likely figure.
8. In October, annual consumer inflation stood at 5.89%, higher than expected by the [illegible] items was the only that pulled inflation downwards, due to the behavior of [illegible] All the indicators of core inflation picked up again and their average stood at 5.11%.
9. In the last month, all the measures of inflation expectations monitored by the technical [illegible] year's stood at 4.41% and 3.55%, respectively. Those obtained from public debt bonds posted above the ceiling of the target range for all periods.
10. It is expected that in the coming months, the effects of El Niño on agricultural production [illegible] with greater intensity than in earlier periods, and generate a slower convergence of inflation to the target.

In summary, inflation expectations have increased and the risk of a slowdown in domestic demand, beyond that which is consistent with the decline registered in national income, has moderated.

2. DISCUSSION AND POLICY OPTIONS

All Board Members agree that the Colombian economy has experienced a strong impact on income derived from the fall in the international price of oil, generating a substantial depreciation of the peso, which is necessary to achieve a sectoral re-orientation of spending and production, leading to the adjustment of the country's external accounts.

Due to its magnitude, devaluation has increased inflation of consumer prices. This increase has been reinforced by other supply pressures, especially on food. Both shocks, although temporary, have been stronger and more persistent than initially forecast, diverting inflation from its target for a longer period of time. The forecasts show that it will begin to converge towards its target in the second semester of 2016.

Meanwhile, the adjustment of domestic demand facing the impact in the terms of trade has been lower than expected, exhibiting reinforcement in the last quarters of the year. This factor has not contributed as much as expected to the reduction in the current account deficit, causing the economy's external vulnerability to continue raising concerns. In this scenario, all the members of the Board agree that it is necessary to continue tightening the monetary policy, although there are differences about the pace of increase of the benchmark interest rate.

The majority of the Board members consider that it is appropriate to continue the tightening process of the monetary policy, seeking to reduce the growth of domestic demand and strengthen the anchoring of inflation expectations. The monetary policy acts with a forward-looking approach. Within an environment in which the economy continues to face changing external conditions, these members believe that announcing a path of continuous 25 bp adjustments is appropriate. A path of increases strengthens the signal of the Board's commitment to inflation targets, allows to better calibrate an optimal response to new external shocks, and makes the movements of the Board of Directors more predictable for the market, thereby improving the pass-though of monetary policy.

The credibility of the monetary authority must be sustained by a consistent and weighted action looking towards the policy horizon. The willingness to follow a path of increases in the benchmark rate that is consistent with the convergence of inflation to its target within this horizon is the best strategy to underpin credibility. A coherent policy should be the guide to adjust medium-term inflation expectations, despite the fact that the volatility of the short-term data will most likely persist for some time.

The other members of the Board consider that it is essential to consolidate credibility of the monetary policy as long as domestic demand is not weak and still contributes to generate vulnerability in the economy by the high deficit in the current account of the balance of payments. They consider that credibility is further consolidated with a 50 bp increase in the benchmark interest rate than with a 25 bp increase in this meeting of the Board. They argue that a 25 bp increase in the benchmark interest rate in this meeting will weaken the signal sent and the credibility obtained from the 50 bp increase of the previous meeting, and that it would be unfortunate to have to make efforts to gain credibility in the future, after the domestic demand has weakened.

The credibility of the monetary policy could suffer more due to some foreseeable supply shocks in the future. Particularly, the imminent increase in the benchmark interest rate of the United States Federal Reserve tends to strengthen the US dollar and reduce the prices of oil, resulting in a higher devaluation of the peso and consequential pressures on inflation expectations. Also, the effect of El Niño on food supply and the prices of some regulated services will further increase inflation, and could additionally affect inflation expectations.

Finally, one of the members from the group that proposed a 50 bp increase stressed that annual inflation to October (-5.9%) doubles the target, is the highest in six-and-a-half years, and has remained above the upper limit of the target range over nine consecutive months. Certainly, food inflation (-8.8%) has been the main inflationary factor. However, this pressure is not only caused by food. Excluding food, inflation went from 2.9% a year ago to 4.8%. Excluding food and regulated items, it doubled, having moved from 2.6% to 5.2%. Besides, the average of the Core inflation increased by thirteenth month in a row, moving from 2.8% a year ago to 5.1%. The persistence of the increase in all Core inflation indicators suggests demand pressures. Expectations are unanchored from the goal, and the large current account deficit shows no signs of abating.

3. POLICY DECISION

The Board of Directors of Banco de la República, by majority, decided to increase the benchmark interest rate by 25 bp to 5.5%.

Bogotá, D. C.