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 Tuesday, March 20, 2018. In attendance were Mauricio Cárdenas Santamaría, Minister of Finance and Public Credit; Juan José Echavarría, Governor of the Central Bank; and Board Members Gerardo Hernández Correa, Ana Fernanda Maiguashca Olano, Adolfo Meisel Roca, José Antonio Ocampo Gaviria, and Juan Pablo Zárate Perdomo.

These minutes contain a summary of the outlook on the macroeconomic situation by the technical staff of the Central Bank (section 1), followed by a review of the main discussion regarding monetary policy 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 quarterly Monetary Policy Report for February 2018 and in the statistical annex (Only Available in Spanish).

1. MACROECONOMIC CONTEXT

1. The average growth forecast for Colombia's main trading partners for 2018 was revised slightly upwards in this report. Additionally, a slight acceleration of GDP for the country's trading partners is estimated for 2019. Thus, the Colombian economy would receive an additional boost next year generated by a stronger external demand.
2. The prices of oil and other raw materials are estimated to reach higher levels than those observed in 2017. This would continue driving the recovery in the country's terms of trade and the positive effects on national income.
3. The most recent information on capital flows to emerging economies and the behavior of risk premia suggest that external financing would not exhibit significant changes in the rest of the year. However, in recent months, the expectations of a less expansionary monetary policy in developed economies has increased; consequently, it is estimated that external financing conditions for 2018 will be less generous than in previous years. This Report assumes four rate increases by the FED during 2018.
4. Forecasts suggest that the country's external deficit should continue correcting in the remainder of the year as a result of a better dynamics of exports of goods and the good performance of current transfers. Thus, a current account deficit close to 3.1% of GDP is estimated in 2018.
5. The Colombian economy grew 1.8% in 2017, which implies a slight deceleration vis-à-vis the

figure for 2016 (2.0%). The international financing conditions, the prices of commodities, and the demand for trading partners are expected to be favorable to the expansion of Colombia's GDP in 2018. Additionally, domestic factors such as the decline in inflation, an expansive interest rate, and a labor market without many variations would strengthen the process of convergence toward the growth potential. Therefore, for 2018, the technical staff maintained its growth projection unaltered at 2.7%.

6. In terms of inflation, the results in the first two months of 2018 have been more favorable than expected by the technical staff and the market. Particularly, in February, the annual inflation rate stood at 3.37%, lower than the figure observed in December 2017 (4.09%). This behavior was explained mainly by the dissipation of the effects of the increase in VAT a year ago and a higher-than-expected decline in food prices.
7. The average of core inflation indicators continued its downward trend, standing at 3.96%. Inflation expectations to December 2018 obtained from the monthly survey to financial analysts posted at 3.35%. Analysts' expectations and those embedded in public debt bonds to horizons greater than or equal to one year stand between 3.42% and 3.67%, except for the estimation of the FBEI curve, which stands at 4.32%.

In all, for 2018, inflation is expected to continue its process of convergence to the target, and economic growth is expected to recover the path towards its potential. The monetary policy actions carried out so far should consolidate the convergence of inflation to its target and maintain a favorable path for GDP growth. However, uncertainty about the external and internal conditions remains high, which could affect the dynamics of prices and economic activity.

2. DISCUSSION AND POLICY OPTIONS

The Board Members highlighted the positive results of inflation in the first two months of the year, which has led headline inflation and the average of core inflation to post at 3.37% and 3.96%, respectively. Food and the tradable CPI excluding food and regulated items were the groups that contributed the most to the fall, added to the fading effects of tax increases at the beginning of 2017. However, some of the most indexed groups, namely education and health, as well as labor-intensive groups, exhibited increases well-above the target so far this year. These results of inflation for the two-month period have been accompanied by a reduction of inflation expectations for the end of 2018 arising from the surveys to financial analysts.

The data available so far this year suggest that the economy has continued to grow slowly, albeit faster than in 2017. The technical staff estimates the growth figure for the end of the year at 2.7%. Factors such as the recovery in external demand, better terms of trade, the effects of the policy of low interest rates followed by the Board, and investment in civil works should contribute to the estimated growth figure for 2018.

The members of the Board also emphasized that, continuing with the orderly adjustment of the economy, the current account deficit reached 3.3% of GDP in 2017, and is estimated at 3.1% of GDP for 2018.

The Board agreed that the current benchmark interest rate (4.5%) is slightly expansionary.

The analysis of the Board focused on: (i) the possible effect of the persistence in some items on the end-of-year inflation, and a less favorable behavior in food inflation; (ii) the slow dynamics of economic activity, the widening of the output gap, and uncertainty about its pace of recovery.

The majority of the Board Members voted in favor of maintaining the benchmark interest rate unaltered. They supported their decision on the risks that persistence of inflation of some goods and services poses to the inflation forecasts, which remain well-above the target, despite the decline that took place in the first quarter. Also, on the dependence of inflation forecasts on the expected behavior of food prices at the end of the year.

This group of Board Members also noted that they observe an improvement in the confidence indicators and in several agents' expectations, despite the fact that economic activity started the year with a weak dynamics. They stressed that the growth figure of the economy expected for 2018 is below its potential. One of the Board Members pointed out that the reduction of the benchmark interest rate agreed in January already incorporated the forecast of the decline in inflation, ratified with subsequent data.

One of the members of the Board voted for a 25 bp reduction of the benchmark interest rate. S/He said that, despite the fact that there are signs of recovery, the figures for economic activity are still weak and could be bolstered by a further reduction of the intervention rate, considering that inflation forecasts continue exhibiting convergence to the 3.0% inflation target in 2018.

3. POLICY DECISION

The Board of Directors of *Banco de la República* decided by majority to maintain the benchmark interest rate unaltered at 4.5 %.

The decision to maintain the intervention rate at 4.5% was approved by six Board Members. The remaining member of the Board voted for a 25 bp reduction.

Bogotá, D. C.