[Monetary Policy Report]

Must reads

[Banco de la República maintains the benchmark interest rate at 4.25%]

A regular meeting of the Board of Directors of *Banco de la República* took place in Bogotá D.C. on Friday, 21 December 2018. In attendance were Alberto Carrasquilla Barrera, Minister of Finance and Public Credit; Juan José Echavarría, Governor of the Central Bank; and Board Members Gerardo Hernández Correa, Ana Fernanda Maiguashca Olano, José Antonio Ocampo Gaviria, Carolina Soto Losada, 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 Monetary Policy Report for December 2018 and in the statistical annex (Only Available in Spanish).

1. MACROECONOMIC CONTEXT

1. Until the third quarter, external conditions favored the performance of the Colombian economy. In recent months, however, the figures observed and projected for oil prices fell, and those for the average growth of the country's trading partners moderated.
2. For 2018 and 2019, the forecasts for the average growth of trading partners were revised downwards to 2.5% and 2.4%, respectively. These growth rates are still higher than those observed in 2015 and 2016 (1.85%, on average). The forecast path for the price of oil was also reduced. For 2018, an average price of US $72 per barrel (Brent) is projected, and of US $66.5 per barrel for 2019.
3. As expected, the Fed increased its reference rate by 25 basis points at its December

meeting.

4. In this environment, an increase in risk premia and in the country's exchange rate has been observed, while a smaller increase in international interest rates is expected compared with the forecasts in the previous report.
5. The new estimates suggest that the adjustment of the external imbalance would have stopped in 2018, and that the current account deficit would widen somewhat in 2019. A current account deficit of 3.6% of GDP is expected in 2018, and a slightly higher one for 2019.
6. In the third quarter, domestic demand turned out better than expected, mainly by investment in construction. Despite this, the technical staff maintained the growth forecast for 2018 at 2.6%. This estimate assumes that part of the positive impact observed in public consumption at the beginning of the year fades in the fourth quarter. Also, that the acceleration in the construction of buildings would have been partly transitory, inasmuch as some indicators related to the performance of the sector remains weak.
7. Observed inflation has been somewhat lower than expected, due mainly to a more favorable performance of prices of food and of tradable goods, and in spite of upward pressures on the group of regulated items. Specifically, in November, annual inflation stood at 3.27%, a figure slightly lower than in the previous month. Since March, inflation has remained relatively stable at a level close to the target.
8. In November, the average of the four core inflation indicators (3.26%) exhibited a similar level to that of the previous months. Inflation expectations to December 2018 obtained from the monthly survey to financial analysts posted at 3.20%. Analysts' expectations and those embedded in public debt bonds to horizons greater than or equal to one year remain above 3.0%.

In summary, observed inflation has been slightly lower than expected, and has remained at values close to the target. Economic activity continues to recover from output levels that have been lower than the productive capacity of the economy. Monetary policy actions taken so far should consolidate the convergence of inflation to the target and maintain a favorable path for GDP expansion. Uncertainty about external financing conditions and the performance of some emerging economies remains high.

2. DISCUSSION AND POLICY OPTIONS

The Board of Directors discussed the following topics:

1.Inflation and Prices

The Board Members highlighted the positive behavior of the inflation indexes. They outlined that both headline inflation as well as core inflation indicators have been converging to the 3.0% target. Similarly, both the projections of the Central Bank's technical staff for 2019 and analysts' expectations to one and two years stand close to the target.

Some members of the Board noted that there is a significant likelihood of shocks that may affect prices in the future. Specifically, they referred to the rising effect on the price level by the following events: (i) the devaluation of the exchange rate produced by non-monetary reasons; (ii) the increase in relative prices of public utilities; and (iii) the increase in the minimum wage above the growth level of labor productivity. Although there are various points of view on the intensity of these shocks and their effect on prices, the Board Members agreed that policy responses must consider the effects of the shocks on the anchoring of inflation expectations to the target.

2. Growth and Domestic Demand

The members of the Board believe that output growth will increase in 2019. However, there is no consensus on the strength of this increase, and, therefore on the evolution of the output gap. The main differences focus on the expected behavior of domestic demand in the coming quarters.

Some Board Members noted that recent data on consumer confidence as well as the difficult environment for external financing do not allow for optimism about the growth of domestic demand in the near future.

In the opposite direction, other members of the Board highlighted elements that allow to forecast a relatively dynamic performance of domestic demand in the first part of 2019. Particularly, they pointed out the following aspects: (i) the positive recent outcomes from industry, trade, and imports; (ii) the favorable behavior of the indicators that provide a broader set of information from surveys and asset prices; and (iii) investment incentives introduced by the Financing Act (*Ley de Financiamiento*).

Finally, some members of the Board stated that with the current information there is great uncertainty on this issue, and that they consider that their best estimate is a moderate growth, higher than the one suggested by the survey on consumer confidence, but lower than expected some months ago.

As for the expected behavior of exports, the Board Members stated that the most likely scenarios for the international environment do not allow to foresee that neither external demand nor the terms of trade will be a significant source for growth in 2019. However, these factors may be partially offset by the recent depreciation of the exchange rate.

3. External Sector and the Balance of Payments

The members of the Board discussed the effects of the external and the domestic situations on the forecast for the balance of payments. Particularly, they reviewed the projection of the current account deficit, its composition, and its financing structure. Regarding this last issue, they underscored the importance of maintaining a high proportion of the deficit financed through foreign direct investment. Also, one Board Member highlighted the importance of the new tax rules (which will govern portfolio investment) to finance the deficit.

Also, the Board emphasized the challenges that an international situation characterized by greater global instability and high uncertainty on global growth may have on the Colombian economy.

4. Policy Stance

Balancing the risks of the aforementioned elements, the members of the Board unanimously agreed to maintain the current monetary policy stance, which they described as slightly expansionary. In the opinion of some of them, this bias is reinforced because the neutral interest rates may have increased as a response to the normalization of monetary policy in the United States.

3. POLICY DECISION

The Board of Directors unanimously decided to maintain the benchmark interest rate unaltered at 4.25%.