AdCap

February 24th, 2016

Colombia's Central Bank last movement

- **Our purpose is to carefully analyze last BRep communiqué, comparing it with last month's (January) in order to determine what Central Bank explicitly said and what was mentioned between lines.**
- **Our main conclusion: Central Bank's restrictive monetary policy would be coming to an end soon.**
- **Two new factors to consider: 1. growth weakness (via consumer confidence) and 2. fiscal policy importance**
- **We see only one more 25 bps hike, taking the repo rate to 6.50%**

BanRep communiqué: Click Here

Facts

- Central Bank hiked 25bps last week.
- Inflationary concerns (as expected), however the communiqué analyzed topics not considered in previous statements: devaluation, fiscal policy, growth and external imbalances

Topic 1: about the decision made, a *cautious movement*

- As expected, Central Bank hiked 25bps.
- BRep made what we think was a **cautious** rate movement despite higher than expected January headline CPI (OBS 1.29% MoM VS EXP 0.91% MoM ≈ Difference 38 bps),
- Last time, when BRep hiked 50bps (October/15), the difference between CPI OBS and EXP was 34 bps

The Board of Directors of Banco de la República increased the benchmark interest rate by 25 basis points

The Board of Directors of Banco de la República at today's meeting decided to increase the benchmark interest rate by **25 bp to 6.25%.** For this decision, the Board mainly took into account the following aspects:

Topic 2: about inflation pressures, a *prudent language*

- Inflation worries are evident, as it can be inferred ...however, despite headline CPI levels, BRep is using what we consider a moderated language.
- January and February communiqué are both similar in terms of inflation description and perspectives.

Annual consumer inflation in January stood at 7.45%, and the average of core inflation indicators posted at 5.73%, **surpassing the forecasts of the technical staff at the Central Bank.** The measures of inflation expectations remain high: those by analysts to **one and two years registered 4.5% and 3.7%,** respectively, while those embedded in public debt bonds to 2, 3, and 5 years are between **4.5% and 5.0%.**

- Despite higher than expected headline CPI, **language is fairly similar than that used in January**.
- New about inflation: «*surpassing the forecasts of the technical staff*»
- However, CPI expectations remain the same in Jan and FEB: «*...4.5% and 3.7%*»
- But, now an upper bound has been included: «*...between 4.5% and 5.0%.*»

The increase in food prices as well as the higher nominal depreciation and its partial pass-through to consumer prices explain the increase in inflation in January. Although they are considered temporary shocks, the magnitude of the depreciation of the peso and the intensity of El **Niño increases the risk of a slower convergence of inflation to the target, due to its direct impact on prices and inflation expectations as well as by the probable triggering of indexation mechanisms**.

- **INFLATION WORRIES: Past communiqué**: «*will slow down convergence of inflation*» VS **Last communiqué** «*increases the risk of a slower convergence of inflation* »

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Topic 3: about S&P outlook cut, a *response based on fiscal measures*

- BRep might prefer fiscal measures over monetary ones. It is VERY RELEVANT that the monetary policy maker elaborates an argument favoring fiscal policy: "*..fiscal policy measures are the most effective instruments"* to manage oil's shock and therefore devaluation.

The price of oil is still volatile and remains below the forecasts for this year. Global risk aversion has increased. In this environment, the largest economies of Latin America recorded once more increases in their risk premia and their currencies depreciated vis-à-vis the US dollar.

The most recent information on global economic activity suggests that in 2015 the average economic growth of Colombia's trading partners was weak, and the forecast for 2016 suggests that its recovery will be somewhat slower than expected.

New declines in oil prices continue deteriorating the terms of trade and are reflected in a further fall of the national income and, especially, of public revenue. Given that part of this fall is long-lasting, a permanent adjustment of domestic spending in the economy is required, **for which fiscal policy measures are the most effective instruments. In this sense, the announced cuts in public expenditure and the firm commitment of the Government to submit a structural tax reform in 2016 are necessary measures for the economy to adjust to the new income levels.**

3 whole new paragraphs in response to S&P?

- S&P outlook cut was a main event. Central Bank dedicated 3 paragraphs
- BRep a monetary policy maker commenting on the importance of fiscal adjustments as : «*necessary measures for the economy* »
- IS THE RESTRICTIVE MONETARY POLICY NEAR TO THE END?

Topic 4 & 5: about external markets and leading indicators, a *warning about growth*

- The comment about FED's future hikes was omitted
- It is rare that Central Bank comments on a specific indicator. In the last communiqué, BRep analyzed Consumer Confidence's weakness and the implications of its downward trend. If CC remains low, it would trigger important concerns about health of the economy (see chart below). We think that this IS the indicator to follow

The most recent figures of economic activity suggest that output growth in the fourth quarter of 2015 would have been similar to that recorded in the third quarter. The dynamism of consumption and investment would have been lower, but net exports would have contributed positively to growth. For all of 2015, economic growth is projected at 3.0% as the most likely figure, within a range between 2.8% and 3.2%.

In January, the **Consumer Confidence Index declined significantly, registering a historically low level. However, uncertainty about the persistence of this low level of the indicator and its impact on household spending is high.** Other indicators of economic activity are compatible with the tech staff's growth forecast for 2016 (2.7% as the most likely figure, within a range between 1.5% and 3.

BRep showing concern about some leading indicators

BRep no longer expecting FED rate hikes? No mention on this communiqué

- For some analysts, Consumer Confidence is a minor data. Not for the Central Bank that dedicated a paragraph showing worries about CC signals.
- Is CC stays low… it is possible to determine that BRep would evaluate restrictive monetary policy effect on growth
- IS MONETARY POLICY NEAR TO THE END?

In summary, higher-than-expected increases in food prices and further increases in the exchange rate, largely related to the fall in the price of oil, continue exerting upside inflationary pressures. Inflation expectations

Topic 6: another reference to fiscal policy, a *comment showing that BRep would prefer fiscal over monetary measures*

- We believe that BRep is favoring fiscal over monetary policy: according to Central Bank, if spending cuts and tax reform are implemented, CAD and inflationary pressures would be reduced.
- We ask, is monetary policy exhausted?

remain high and an additional pass-through of the devaluation of the peso to domestic prices is foreseeable.

The Board of Directors decided to continue with the path of 25 bp increases of the benchmark interest rate, and will be particularly attentive to the behavior of inflation and its expectations in order to ensure convergence of inflation to its target in 2017. **At the same time, the cuts announced in public spending and the firm commitment of the National Government to submit a structural tax reform this year, contribute to reduce the current account deficit and inflationary pressures.**

Again, a strong reference favoring fiscal over monetary policy

- Fiscal policy time? «*...cuts announced + a structural tax reform = reduce CAD and inflationary pressures*»
- IS MONETARY POLICY NEAR TO THE END?

Topic 7: about devaluation pressures

- We think that Central Bank is worried about COP weakness: for the first time in the last year, we perceive that BRep shows some concern about currency devaluation (pass-through). FX intervention threshold was tightened from 7%, then to 5% and now to 3%

On the other hand, with the purpose of mitigating the **impact of an overreaction of the exchange rate on inflation expectations and contributing to preserve the conditions of liquidity of the foreign exchange market, the Board decided to modify the percentage for the activation of the auction of options to disaccumulate international reserves and their exercise from 5.0% to 3.0%.** The other conditions of the mechanism remained unaltered.

- Is devaluation a new concern? We think so: now it is easier to exercise call options
- The condition was tightened from 7%, then to 5% and now to 3%

The Board reiterates its commitment to the inflation target and continues to carefully monitor the behavior and projections of economic activity and inflation in the country, as well as that of asset markets and the international situation.

Bogotá,
Friday, 19 February 2016
15:20

- The earlier the communiqué is released ...the lower the hike is

Conclusion:

- We believe that Central Bank's statement shows relevant concerns about economic growth.
- As a whole, communiqué shows that Central Bank believes that monetary policy would no longer be the best way to deal with Colombia's current problems.
- If monetary policy is no longer the most preferred tool, repo rate hikes would be finishing soon

What-to-watch

COL Industrial Confidence	:	Thursday, February 25th
COL Unemployment rate	:	Monday, February 29th @10:00 COL // PER // EST
COL CPI	:	Saturday, March 5th @ 12:00 COL // PER // EST
COL Central Bank Minutes	:	Friday, March 11th @13:00 COL // PER // EST

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