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Latam Daily: BanRep Worries About Inflation Expectations as Headline Rate Rises

- **Colombia: BanRep's Board expresses concern about inflation expectations becoming unmoored, while headline rises to 22-year high**

COLOMBIA: BANREP'S BOARD EXPRESSES CONCERN ABOUT INFLATION EXPECTATIONS BECOMING UNMOORED, WHILE HEADLINE RISES TO 22-YEAR HIGH

I. BanRep Minutes reveal concerns about inflation expectations, but also affirm data-dependent approach

On Tuesday, July 5, the central bank released the Minutes of its most recent monetary policy meeting held on Thursday, June 30, in which BanRep's Board of Directors decided to increase the monetary policy rate by 150 bps in a unanimous vote.

The board agreed that an acceleration in the hiking cycle would help achieve the inflation target of 3% in the medium term. Board members also highlighted the strength of economic conditions, as the output gap has closed. There was a consensus regarding the potential risk from a de-anchoring on inflation expectations, and that some factors could lead to even higher inflation. These factors include strong private consumption, FX depreciation, international commodity prices, and the expected reduction in gasoline prices' subsidies.

One member turned hawkish and said that further upside deviation in the inflation expectations should motivate a stronger adjustment in the monetary policy rate.

Another member pointed out that there are limitations in the analytical tools owing to the covid shock, which render conventional tools less effective in easing inflation over the policy horizon. In fact, this member said that other countries have conducted a restrictive monetary policy, which reduces growth, but still face high inflation pressures.

The majority of the board members said that high uncertainty makes it difficult to anticipate next steps. That said, they emphasized that the data-dependent approach will prevail and the decision to increase the rate by 150 bps in June is not a guarantee of rate increases of the same magnitude in the future.

All in all, the minutes revealed a strong concern regarding the inflation expectations dynamic, while in terms of economic activity the board still sees a robust performance. As the board mentioned, uncertainty remains high, but from our point of view the hiking cycle is likely to extend longer than expected, with the terminal rate exceeding our current forecast of 8.50%.

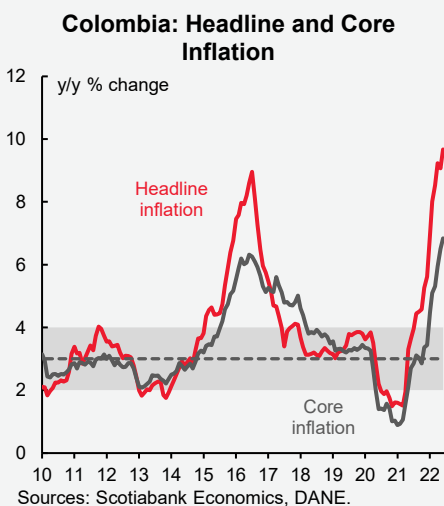
II. Headline inflation at highest in 22 years as core components lead increases

Monthly CPI inflation was 0.51% m/m in June 2022, according to DANE data published on Tuesday, July 5, consistent with BanRep's survey (0.51% m/m) and below Scotiabank Economics' projection (0.71% m/m). June inflation was 5.2 times the average monthly inflation observed since 2016 (0.10% m/m) and the highest in eighteen years. On a year-over-year basis, headline inflation stood at 9.67% y/y, up from 9.07% y/y in April (chart 1), the highest in 22 years.

Food inflation eased from 1.56% m/m to 0.65% m/m, however, due to a low statistical base effect, the annual food inflation increased from 21.60% y/y to 23.65 %y/y.

Core inflation increased again, from 6.50% y/y to 6.84% y/y, the highest level since December 2003, while ex-food and regulated goods inflation came in at 6.06% y/y (up from 5.87% of the previous month), the highest level since August 2016. June's results show that inflation upside pressure is now coming mainly from items other than food,

Chart 1



amid relevant indexation effects in rent and utility fees. In the same vein, tradable goods prices are still increasing at a significant pace reflecting higher international costs and COP depreciation.

In our opinion, June's COU print is likely to motivate at least a 100 bps rate hike for July's monetary policy meeting (July 29), as economic activity remains strong and inflation is showing greater upside pressures in core components. We expect July's y/y headline inflation to remain high although should moderate slightly if food inflation eases further. As BanRep highlighted, uncertainty is high, and despite our current scenario of a hiking cycle ending in July at 8.50%, if inflation doesn't moderate significantly and inflation expectation rises again, the central bank would consider additional moves in September's meeting.

Looking at May's numbers in detail, 10 out of the 12 components of the CPI index contributed to higher inflation (charts 2 and 3). In contrast to recent months, however, foodstuffs were not the main contributor.

The main highlights are:

- **Foodstuffs inflation moderated, with the lowest monthly increase since July 2021.** In June, there was an offsetting effect between increases in the prices of meat (+2.6% m/m), chicken (+2.1% m/m); milk (+2.1% m/m), rice (2.1% m/m) and sugar (+7.6% m/m), and price declines on potatoes (-20% m/m), bananas (-5.4% m/m), onion (-9.9% m/m) and tomatoes (-13.5% m/m). Food inflation will continue to exert price pressures in coming months, as input prices are still increasing, however, inflation is expected to be lower than in H1-2022.
- **The largest contribution to overall inflation (+17 bps) came from the lodging and utility group (+ 0.54% m/m).** In this group, utility fees (+0.54% m/m) are showing the effect of indexation, especially in water prices (+1.13% m/m), and the impact of the FX depreciation, particularly with respect to gas prices (+2.35% m/m). In the same vein, rental fees (+0.20 % m/m) are also increasing more strongly. These increases are the main source of concern to us, since they can continue to push inflation up as indexation rules are consistently triggered.
- **The VAT holiday effect provided some relief from inflation.** The clothing group (-2.64% m/m) accounted for the largest contraction, subtracting 9 bps from the overall figure. It is worth noting that this effect will be reversed in July.
- **Across the remaining groups, inflation reflected upside contributions from tradable goods,** showing that the FX depreciation, and more importantly international bottlenecks, are also transmitting price pressures through other core components.

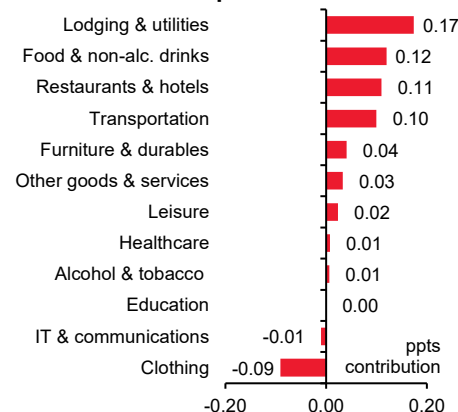
Looking at annual inflation across major categories, goods inflation moderated from 8.51% y/y to 8.30% y/y amid the VAT holiday, while services increased from 4.87% y/y to 5.21% y/y. Regulated-price inflation increased 94 bps to 9.80% y/y.

All in all, June inflation was aligned with the consensus expectation. Foodstuff was no longer the main contributor, but core components such as lodging and utilities are still showing strong upside pressures. That said, core inflation increased again. Inflation expectations, in our opinion, are likely to continue to increase as gasoline subsidies started to be withdrawn.

All of the above leads us to expect at least a 100 bps move in BanRep's July 29 meeting. The terminal rate of the current hiking cycle will be strongly dependent on incoming data, and our current forecast of 8.50% could be revised up if CPI shows a stronger FX pass-through effect.

Chart 2

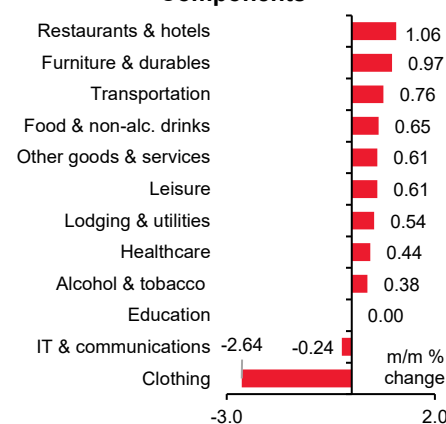
Colombia: Consumer Price Index Components



Sources: Scotiabank Economics, DANE.

Chart 3

Colombia: Consumer Price Index Components



Sources: Scotiabank Economics, DANE.

—Sergio Olarte, Maria (Tatiana) Mejía & Jackeline Piraján

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