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Latam Daily: Colombia's BanRep Releases Latest *Monetary Policy Report*

- **Colombia: *Monetary Policy Report* reveals high uncertainty, hawkish staff**

COLOMBIA: *MONETARY POLICY REPORT* REVEALS HIGH UNCERTAINTY, HAWKISH STAFF

On Monday, August 1, the central bank staff released the latest *Monetary Policy Report (MPR)* updating their assessment of the current macroeconomic scenario and the near-term balance of risks. The *MPR* reveals a hawkish BanRep staff advocating restrictive monetary policy to avoid a further deviation of inflation expectations from BanRep's target, even if that implies a strong deceleration in private consumption. That said, despite projecting a 6.9% GDP expansion in 2022, the staff assumes a strong deceleration in 2023 to 1.1% as a result of a moderation in private consumption from tighter domestic financial conditions. This would be the weakest growth since 2009 (excluding the pandemic). In addition, the staff projects an increase in the neutral rate, with a higher monetary policy rate lasting longer than anticipated. They also said that the monetary policy rate path is, on average, above the level expected in the last survey. The staff notes, however, that uncertainty remains high, largely owing to international forces.

Main highlights include:

- **The international environment has led to tighter-than-expected financial conditions.** Uncertainty remains high with respect to the possibility of the Federal Reserve further hiking rates. BanRep staff estimate a higher risk premium owing to international issues but also local factors such as the still high external and fiscal deficit. These factors contributed to a higher estimate of the real neutral rate, estimated at 2% (1.8% previously) for 2022, and 2.2% (1.9%) in 2023. **At this point, risks remain tilted to the upside, with the staff leaning to structurally higher rates.**
- **Upside price pressures have been higher than anticipated.** Headline inflation is expected to close 2022 at 9.7% (previously 7.1%) and 5.7% in 2023 (4.8%), where these projections include higher gasoline prices and indirect impacts from those increases. Nevertheless, strong demand is leading to high inflation in 2022, while indexation effects are expected to push inflation from the target range in 2023. That said, by Q2-2024, the staff projects inflation at 3.9%, slightly below the ceiling of the target range.
- **Projections point to core inflation of 7.5% by December 2022, 6.1% in December 2023, and 4.4% by mid-2024.** The persistence in core inflation is explained by the expiration of some tax breaks for the tourism sector, formal restaurants, and health-related goods.
- **BanRep staff anticipates GDP growth of 6.9% for 2022 (above the previous forecast of 6.3%).** While the first half of 2022 has been stronger than expected, owing especially to household consumption, the staff projects a deceleration attributable to higher domestic interest rates and a less favourable international context. Investment has been more moderate than expected, but a gradual recovery remains the base case scenario, albeit still closing 2022 below pre-pandemic levels. BanRep staff cut its GDP growth forecast for 2023 from 2.9% to 1.1%, reflecting the moderation in private consumption and a challenging international environment. A scenario of stronger growth is compatible with a robust recovery in employment. The unemployment rate is expected to average between 10.2% and 11.5% this year.
- **All in all, the staff estimate a positive output gap, which is expected to close in 2023 as private consumption moderates.** However, potential GDP growth also declined from the previous *Report*, reflecting higher rates that will have an impact on the investment side too.

- **The 2022 current account deficit is estimated at 5.1% of GDP, with the effects of higher commodity prices on exports and stronger economic activity the main contributors to this projection.** Nevertheless, the deficit would remain around USD 17 bn in nominal terms, which represents a drag on the currency.

***Monetary Policy Report* (press conference):**

During the press conference on Wednesday, August 3, BanRep's Chief Economist, Hernando Vargas, emphasized that private consumption in Colombia is well above its long-term trend, something not observed in other countries. That said, he noted that consumption would decelerate to more sustainable levels as domestic financial conditions tighten. However, he also recognized that tighter financial conditions affect investment and thus potential GDP growth. **In his remarks, the Chief Economist softened the perceived hawkish tone in the *Report*, highlighting that uncertainty is still high with upside risks on inflation and downside risks on economic growth.**

Another interesting signal came with the assessment that the monetary policy rate is no longer expansive, a signal that the hiking cycle is approaching the end and that in coming meetings the Board may start to balance how contractionary they would like to go. The data-dependent approach remains, however, and it will be relevant to continue monitoring the economic activity performance and the evolution of inflation expectations.

All in all, BanRep's macroeconomic scenario points to a higher inflation path, a stronger than expected economic activity in 2022, and a higher neutral real rate. This leads the staff to project an interest rate path in 2022 above market expectation, signaling that the staff is calling for a terminal rate that is higher and which prevails for longer. Either way, as uncertainty remains high, it is key to continue closely monitoring the evolution of economic activity and inflation risks.

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