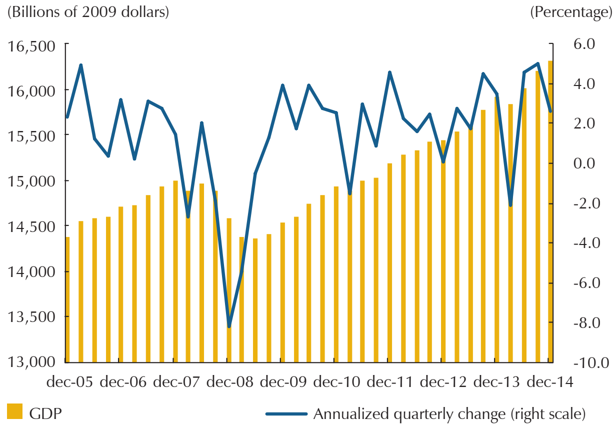
Developments in inflation and monetary policy decisions

The various indicators of economic activity in the fourth quarter of 2014 reflect vigorous domestic demand. Retail sales performance, consumer lending and consumer confidence suggest household spending accelerated during that period. There appears to have been important growth in investment as well, both in civil works and in machinery and equipment, and transportation equipment. It is estimated that the contribution from net exports was negative, due to a slowdown in exports. Given this information, the technical staff at *Banco de la República* is forecasting around 4.0% growth in the fourth quarter of 2014 and nearly 4.1% in the second half of the year. While this would imply less momentum than during the first six months of 2014, the country's economic performance continues to be remarkable for the region. GDP growth in 2014 would have been between 4.5% and 5.0%, with 4.8% being the most likely figure.

Oil prices on the international market plunged as of the third quarter of 2014, particularly during the last three months of the year. In fact, by December, the price of oil was 50% below the levels witnessed at mid-year. The net impact of this decline on global economic growth is likely to be positive, but mixed. Oil importing countries will benefit, thanks to household budget relief, lower input costs, and an improvement in their external position. However, oil exporting countries will be affected by a drop in their revenue and the pressure this would exert on their public finances and external balances.

In Colombia, the impact of lower oil is negative, since 55% of the value of the country's exports in dollars pertains to oil. The effect of this shock passes through to the economy via different channels. The most important one is deterioration in the country's terms of trade. This is reflected in a drop in national income and investment, as well as deterioration in Colombia's trade balance. Lower prices also reduce capital inflows, especially for foreign direct investment, a third of which went to the oil sector during the

Graph 1
Real GDP in the United States



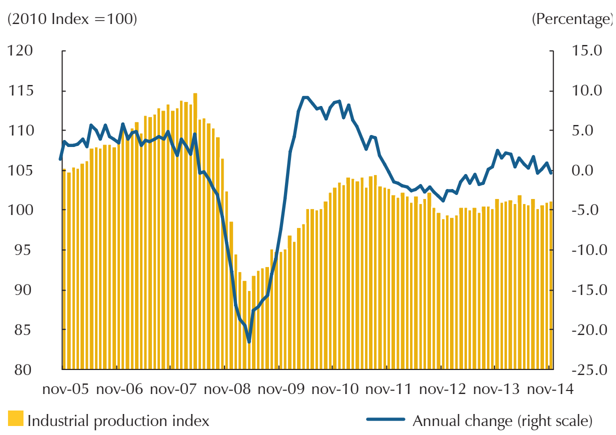
Source: Bureau of Economic Analysis.

3.2% to 4.3% a.q. Meanwhile, although the rate of investment slowed with respect to the preceding quarter, it was favorable (2.3% a.q). In contrast, net external trade detracted from the expansion in real activity, due to an increase in imports (8.9% a.q.) that outpaced export growth (2.8%). In the same time, the quarterly variation in government spending was negative, given the high base of comparison from the previous quarter, when there was a significant increase in defense spending.

The good performance of real activity of the United States has allowed its job market to continue recovering. Job creation remained dynamic: nonfarm payrolls increased at an average monthly rate of approximately 324,000 new jobs during the fourth quarter and 260,000 for the entire year, which is the best growth on record since 1999. Consequently, the unemployment rate stayed on a clear downward trend, declining from 6.6% at the beginning of the year to 5.6% in December.

Other job market indicators monitored by the Federal Reserve (Fed) are still above those recorded prior to the financial crisis in 2008, but improved significantly during the year. For example, long-term unemployment[1] and underemployment[2] are down considerably; this suggests surplus capacity in the US labor market continues to decline and the quality of the jobs being created has improved.

Graph 2
Euro Area Industrial Production Index



Source: Datastream.

In contrast, third-quarter GDP figures for the euro area showed very weak growth (0.2% against the previous quarter), and the latest indicators suggest this situation persisted throughout the final quarter of 2014. Taking into account the figures up to November, the annual change in industrial production data was negative (Graph 2), while exports to countries outside the euro area and retail sales posted very modest annual growth.

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1 (Note 1) This is the number of people who have not found employment in more than 27 weeks, as a share of total unemployment.

2 (Note 2) This refers to the total number of unemployed, part-time employees who want full-time work and those outside the labor supply who would be willing to work if they could find a job (marginally linked to the job market), as a portion of the workforce and those marginally attached to the job market.

Table 1
Growth Forecasts for Colombia's Major Trading Partners

Growth forecasts for Colombia's trading partners	2013	Forecasts for 2014			Proyecciones para 2015		
		Scenario			Scenario		
		Minimum forecast	Baseline forecast	Maximum forecast	Minimum forecast	Baseline forecast	Maximum forecast
Main partners							
United States	2.2	2.3	2.4	2.5	2.4	3.0	3.6
Euro Area	(0.5)	0.7	0.8	0.9	0.2	0.9	1.6
Venezuela	1.3	(5.0)	(4.0)	(3.0)	(6.0)	(4.0)	(2.0)
Ecuador	4.5	3.4	3.8	4.2	2.0	3.0	4.0
China	7.8	7.2	7.3	7.4	6.4	7.0	7.5
Other partners							
Brazil	2.5	(0.1)	0.1	0.2	0.0	0.7	1.2
Peru	5.8	2.6	2.8	3.0	3.0	4.7	5.5
Mexico	1.4	2.0	2.2	2.4	2.3	3.3	4.0
Chile	4.1	1.5	1.7	1.9	2.5	3.0	3.5
Total trading partners (non-traditional trade-weighted)	**3.0**	**1.4**	**1.7**	**2.0**	**1.1**	**2.0**	**2.8**
Developed countries[a/]	**1.3**		**1.8**			**2.4**	
Emerging and developing countries[a/]	**4.7**		**4.4**			**4.3**	
Total worldwide[a/]	**3.3**		**3.3**			**3.5**	

a/ IMF forecasts at January 2015
Source: Calculations by Banco de la República

allowing an increase from 2.1% to 2.4%[4] in the whole year forecast 2014 annual growth.

For 2015, lower oil prices are expected to provide an additional boost to disposable household income. If so, consumption in the United States should continue to grow at relatively high rates and become the primary driver of that country's economy. Additionally, investments other than those in the oil sector would remain at favorable levels and, in this way, the persistent surplus capacity in the job market would continue to be eliminated. Foreign trade would contribute little to the increase in real activity, because of a lower global demand and the appreciation of the dollar against the major currencies. In this context, the forecast for 2015 would be 3.0%.

4 (Note 4) Figures on economic growth in the United States during the fourth quarter were not available when these forecasts were made.

The risk of the euro zone entering a deflationary spiral persists, with major consequences for economic growth.

Another important risk is the possibility that the euro area will enter a deflationary spiral that adversely affects the balance sheets agents with high levels of debt and that defers their consumption and investment decisions. Likewise, there also might be quite an increased uncertainty about Greece's fiscal sustainability, leading further increases in the cost of funding for that economy and even, in an extreme scenario, to the possibility of a Greek exit from the euro area. This situation would affect other economies in the region and have a negative impact on confidence.

Finally, monetary policy normalization in the United States could have an adverse impact on financial markets and on business and household confidence worldwide. This would affect consumption and investment decisions, as well as capital flows to emerging markets.

B. BALANCE OF PAYMENTS

1. Third-quarter Figures

The current account deficit for the first three quarters of 2014 came to 4.6% of GDP (USD 12,855 m), more than during the same period last year (3.3% of GDP, USD 9,210 m). This increase evidences deterioration in the country's external balance, mainly because of the drop in oil prices, the supply shocks that affected the coal sector and petroleum products during the year, and the momentum in imports. Colombia's trade balance of goods showed an accumulated deficit of USD 1,340 m by September, having registered a surplus by the third quarter of 2013. This is the result of an annual decline in total exports equal of 1.1% by the third quarter of 2014, compared to a 7.8% import growth during the same period. This outcome for the trade balance was accompanied by a slightly higher deficit in services, pressured in particular by net outflows for travel and transportation, and by lower net income from current transfers, mostly due to the sharp decline in worker remittances from Venezuela. Net outflows of factor income continue to decline in relation to the levels observed in 2013, given reduced remittances of profits from direct investments in the country, especially those associated with the mining-energy sector.

The deteriorating external balance in 2014 was associated with the collapse of oil prices, the supply shocks that affected coal and refined products, and the momentum in imports.

The current account deficit was financed between January and September 2014 with USD 12,789 m in net income from the capital and financial account (4.5% of GDP). This represents an increase with respect to the previous year (USD 8,480 m or 3.1% of GDP). By September, foreign portfolio investment was the main funding source, with USD 10,934 m in net inflows. This reflects a sizeable increase in flows to the market for local government debt (an effect of rebalancing the JP Morgan emerging market bond soon as the forecasts for the end of 2014 were taken into account, at which point the change in the trend in crude prices became more pronounced (Tables B1.1 and B1.2).

Table R1.1
Forecast Error Analysis: Market Analysts' Forecasts (2013-2014)

Date	Steps Forward	MFE	MAD (USD)	MAPD (%)	MASE
Mar-13	5	-	3.04	2.85	3.22
Jun-13	5	-	2.60	2.47	4.67
Sept-13	5	-	8.13	9.73	4.42
Dec-13	5	-	7.74	9.09	4.21
Mar-14	4	-	8.77	10.57	2.98
Jun-14	2	-	18.95	23.56	1.45

Source: Authors' calculations.

Table R1.2
Forecast Error Analysis : Futures Contracts (2013-2014)

Date	Steps Forward	MFE	MAD (USD)	MAPD (%)	MASE
Mar-13	5	+	4.04	3.73	4.07
Jun-13	5	+	5.57	5.11	6.07
Sept-13	5	+	8.50	7.78	5.64
Dec-13	5	-	12.70	19.95	3.82
Mar-14	4	-	17.63	27.73	3.39
Jun-14	2	-	30.91	50.86	1.59

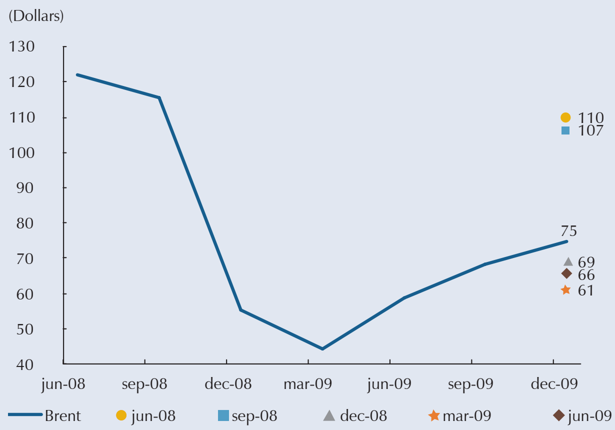
Source: Authors' calculations.

The plunge in oil prices at the end of 2008 was analyzed as well. For that period, analysts forecast that the price would not remain above USD 100 / bbl as of the end of 2008 and would return to the levels observed in the second half of 2007; namely, between US $ 75 / bbl and USD 90 / bl. However, the price dropped far more than expected.[7] The forecast errors showed larger deviations than those pertaining to the event in 2014, since the drop in 2008 was preceded by sharp hikes in the price of crude.[8]

What agents expected one year forward, after the drop in oil prices during late 2008, was examined as well. On that occasion, the forecasts in December 2008 and in March and June 2009 captured the subsequent recovery in prices, but underestimated its magnitude. While the average price in the final quarter of 2009 was USD 75/bl, analysts expected between USD / bl 61 and $ 69 / bbl (Graph B1.4).This underestimation was even larger in the futures contracts (Graph B1.5).[9]

The forecast error analyses show that projections made by analysts and those implied in futures contracts are

Graph B1.4
Observed Brent Crude Price and Forecasts in the Last Five Quarters for the Average Price in the Fourth Quarter of 2009
(Quarterly average)



Source: Bloomberg.

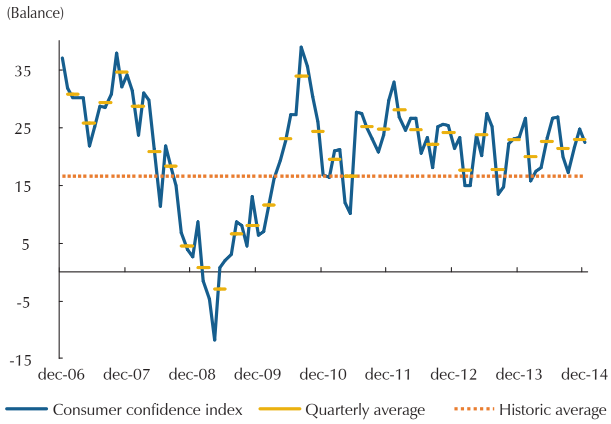
forecast error (MFE), which indicates if the forecast errors, on average, were above or below observed values (a positive sign shows a downward bias in the forecast and a negative sign, an upward bias); ii) the mean absolute deviation (MAD), which is the mean deviation of the forecast in dollars (absolute value) ; iii) the mean absolute percentage deviation (MAPD), which is the mean percentage deviation of the error and, finally, iv) the mean absolute scaled error (MASE). This last measure is the ratio of the sum of the forecast errors to the average of the errors shown by the naïve forecast, which is equal to the value actually observed in the immediately preceding third quarter. If it is less than 1, the forecast in question is better than the naïve forecast; if it is above 1, it is worse.

7 (Note 7 Box 1) The gap in the future contracts was even greater, since the price at the end of the year was US 36/bl as opposed to USD 131/ bl anticipated six months earlier.

8 (Note 8, Box 1) Neither analysts nor futures contracts anticipated the sharp rise observed between March 2007 and June 2008 or the subsequent drop at the end of last year.

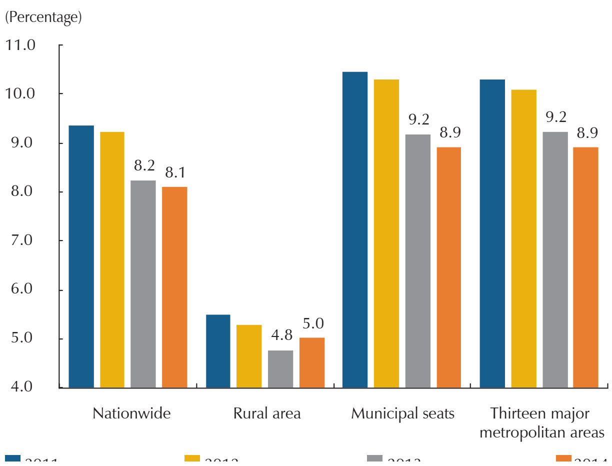
9 (Note 9 Box 1) The assessment shows a significant forecast error, which is corrected later to some degree, once agents included the actual decline.

Graph 20
Consumer Confidence Index and Quarterly Average



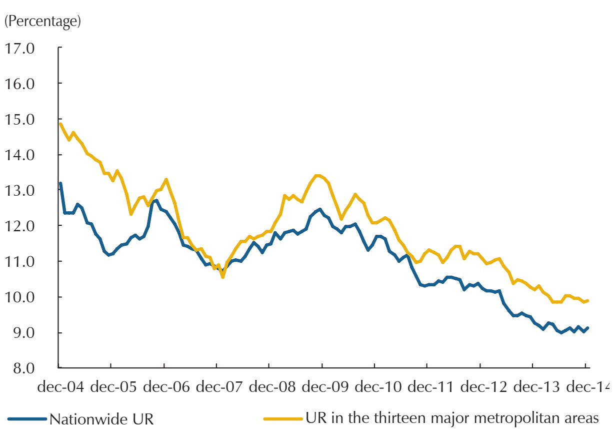
Source: Fedesarrollo.

Graph 21
Unemployment Rate (UR)
(October-November-December moving quarter)



Source: DANE (GEIH); calculations by Banco de la República

Graph 22
Unemployment Rate Nationwide and in the Thirteen Major Metropolitan Areas
(Seasonally adjusted moving quarter)



Sources: DANE (GEIH); calculations by Banco de la República.

index published by Fedesarrollo. December data for the fourth quarter average was slightly higher than the third quarter level, but similar to the 2014 whole year average (Graph 20). It should be noted this indicator exceeded, yet again, the historical average since 2001.

Job market performance continued to favor growth in household consumer spending. The data up to the moving quarter ended in December, shows that the unemployment rate (UR) was down again, reaching 8.1% nationwide, 5.0% for rural areas and 8.9%, for both urban centers and the thirteen major metropolitan areas (Graph 21). Discounting seasonal effects, the UR series maintains during the fourth quarter the low levels reached in previous months (Graph 22).

Recent UR behavior is explained primarily by employment momentum. This is shown by the increase in the number of occupied persons, which rose at an annual rate of 2.4% nationwide and 3.7% in the thirteen major metropolitan areas during October-December (Graph 23).

Employment growth, in turn, is attributed to the situation with salaried jobs, which increased at an annual rate of 5.2% in the thirteen major metropolitan areas during the moving quarter ended in December, while the annual rise in non-salaried jobs was 2.1% for the same period and domain (Graph 24).

Finally, fourth-quarter consumer loan portfolio nominal growth shows a build-up, suggesting that private consumption increased at a good pace during that period. This portfolio posted a 13.0% annual growth rate during October-December, as opposed to 11.8% in the third quarter. When analyzing credit access cost, it is apparent that household loans' real interest rates continued on a downward trend during the fourth quarter (Graph 25). This was largely due to rising prices towards the end of the year and was not offset by movement in the nominal rates on financial markets.