BOARD OF DIRECTOR'S REPORT TO THE **CONGRESS OF COLOMBIA**

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REPORT OF THE **BOARD OF DIRECTORS** TO **CONGRESS**

Banco de la República
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Bogotá, 03 August 2021

PRESIDENTS AND OTHER MEMBERS
Honorable Chairmen and Members
Standing Constitutional Committees
The Senate of the Republic
The House of Representatives

Dear Sirs:

In compliance with Act of Congress 31/1992, Article 5, the Board of Directors of *Banco de la República* hereby submits to the honorable Congress of the Republic of Colombia a detailed report on the measures that *Banco de la República* has taken in the emergency situation generated by Covid-19 and presents the macroeconomic results for the first half of 2021 and the outlook for what remains of the year for its consideration. Furthermore, the breakdown of the foreign reserves and their performance, the financial position of the Bank and its forecasts, and the changes in payments in the Colombian economy are described.

Cordially,

L Villar

Leonardo Villar Gómez
Governor

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01/ Executive Summary

In the first quarter of 2021, the Colombian economy had better-than-expected growth. This was led by a strengthening of domestic demand, which, in turn, was spurred by the reactivation of both consumption and investment. In addition, there was a quarterly rebound in exports in response to the improvement in the terms of trade and the recovery of external demand. As reported by DANE through the economic tracking index (seasonally adjusted EMI and calendar day adjustment -DAEC), this growth continued in April despite the restrictions on movement imposed in some cities due to a resurgence of the pandemic. In May, the strikes and road blockades interrupted this positive performance with a -5.8% monthly change in economic activity based on the EMI DAEC estimate for that month. Despite that, the positive economic performance up to April warranted an upward revision of the GDP growth forecast for 2021 by the technical staff at the Bank. National and foreign analysts also adjusted their growth estimates for the current year upward. The uncertainty surrounding these forecasts is high and makes it necessary to weigh the positive and negative factors on which the outcome depends.

Positive domestic factors that have helped drive the economy's recovery include the reopening of various productive activities, improvements in consumer and business confidence, an expansive monetary policy, ample credit conditions, a fiscal policy geared towards supporting household and company income, and progress on the Vaccination Plan. In addition, there were favorable external factors such as our trading partners' improved performance and the recovery of the terms of trade that were mainly due to the rise in crude oil prices.

Several of these factors are subject to contingencies. For example, the technical staff assumed that no new restrictions would be imposed on movement and that economic activity would not be affected by disruptions to public order or blockades similar to those in May. Moreover, as the Board of Directors of *Banco de la República* (BDBR) has warned, the window during which monetary policy will be able to continue supporting the recovery of the economy and employment could be reduced if there is no adjustment to public finances that will guarantee their sustainability and allow the government to retain access to sources of financing at reasonable costs. It is also necessary to ensure the total reopening of all sectors of the economy. On the foreign front, uncertainty regarding global economic activity remains high, particularly because of the implications of the new strains of the virus. Disruptions in global supply chains could continue to affect or limit the expansion of industrial production and put upward pressure on inflation on a worldwide scale. Finally, the risk of tighter international financial conditions is arising due to inflationary pressure in the United States and other developed economies.

The following sections expand on and complement the points mentioned above, and they will be developed in greater detail in the body of the Report.

Banco de la República's Response to the Covid-19 Pandemic

Monetary policy decisions by *Banco de la República* are governed by the inflation targeting strategy with a flexible exchange rate that was adopted at the end of 1999.

Within this strategy, monetary policy management has consistently met the 3.0% inflation target yearly and with output growth at around the economy's potential capacity. This has made it possible to anchor inflation expectations around the target and carry out a counter-cyclical monetary policy that has contributed to the country's macroeconomic stability. The flexibility of the exchange rate as a basic element of the inflation targeting plan has been essential for achieving the economic adjustments required in the wake of the shocks that the Colombian economy has received during the last few years.

In the context of that strategy, the BDBR acted swiftly and forcefully to mitigate the economic effects of the pandemic, as explained in detail in the March Report to Congress.

The Bank's actions were focused on three basic objectives geared towards: 1) protecting the payment system; 2) stabilizing the foreign exchange market and the public and private debt market, and 3) ensuring that credit continued to flow into the economy. To this end, the Bank significantly increased liquidity provisions by expanding amounts, counterparties, and eligible collateral for their repo transactions, the final purchases of public and private debt securities, and the reduction in legal reserve requirements. They also made non-delivery forward sales of US dollars and dollar swaps to expand the coverage and provide liquidity in dollars to reduce the pressure on the exchange market. Moreover, they reinforced the country's international liquidity position by purchasing foreign reserves and the renewal and expansion of the Flexible Credit Line (FCL) with the International Monetary Fund (IMF), which reduced the uncertainty about the country's foreign financing and its ability to meet payments abroad.

The Bank also focused its efforts on supporting the reactivation of economic activity. To this end, the policy interest rate was reduced by 250 basis points (bp) from an initial level of 4.25% in February to 1.75% in September 2020, thus placing it at a historic low. In addition, the average reserve requirement was lowered and therefore went from 7.0% to 5.0%. This reinforced incentives for financial intermediation and permanently freed up funds for the economy.

These policies were successful in achieving the proposed goals. The public and private debt markets were stabilized and the pressure on the exchange rate was alleviated while the payment system continued to work properly. The reduction in the policy interest rate was transmitted to the different types of credit in the economy at high levels while, at the same time, the credit supply held steady and, in some cases, rose. This helped to create the appropriate conditions for spurring an economic recovery in the second half of 2020.

Over the course of 2021, the persistence of a large excess productive capacity, as well as inflation and inflation expectations close to the target, have allowed monetary policy to remain expansionary. Looking ahead, the degree of stimulus that monetary policy will continue to provide the economy with will be determined by the trend in inflation and inflation expectations concerning the target, the changes in excess productive capacity, foreign and domestic financial conditions, and the progress in fiscal consolidation.

International Macroeconomic Environment

After the 3.2% contraction in 2020, the IMF is forecasting a global economic recovery of around 6.0%, higher than initial forecasts, in 2021. The expansionary fiscal and monetary policies in the major economies have been a significant factor in driving such a recovery, as has progress in vaccination and the reopening of several of the world's major economies. The changes in the pandemic, given the emergence of new strains of the virus, remain a major source of uncertainty.

The differences in the speed of recovery between regions and countries are notorious and depend on the disparities in the impact of the pandemic, coverage, and rate of vaccination against the virus and the countries' ability to respond to the crisis. Among the developed economies, the positive trend in the United States, for which the IMF forecasts 7.0% growth this year, stands out. China, with an expected growth of 8.1% in 2021, stands out among the emerging countries.

In the case of Latin America and the Caribbean, the IMF forecasts a recovery of 5.8% in 2021 after the 7.0% drop seen in 2020. Growth is also expected to differ from country to country in this region. This includes a moderate recovery rate for Brazil and a high one for Peru. Several of these countries are likely to benefit from larger demand for their exports and better prices for raw materials. These countries include some of Colombia's main trading partners.

The recovery of foreign trade has occurred in a context of rising transportation logistics costs and deterioration in the supply chains, which is putting pressure on global inflation. This has driven up the international prices of supplies and products, including crude oil, minerals, and food.

Economic Activity

Economic activity during the first quarter of the year was better than the technical staff at *Banco de la República* had expected as it expanded 1.1% annually, which was equivalent to an annual growth of 2.0% in the DAEC series. This growth was spurred by the sustained reopening of several production sectors, the better performance of our trading partners, the fiscal measures taken to support households and businesses, and expansionary monetary policy. Together with increased consumer and business confidence, these factors contributed to a notable strengthening of domestic demand with private consumption and housing investment playing a major role.

Total exports also made contributed to the quarterly recovery by achieving a visible improvement over the declines in previous quarters even though their levels remained below those registered before the pandemic.

This positive performance was maintained in April despite the restrictions on movement imposed in some cities due to the resurgence of the pandemic. Thus, EMI DAEC estimated a 29.3% annual increase in economic activity for April compared to the low statistical base for the same month in 2020. Nevertheless, the abovementioned restrictions adversely affected some sectors such as commerce, transportation and lodging.

The recovery trend of the economy was interrupted by the roadblocks and severe disruptions to public order that occurred in May. This situation affected the ability of supply chains to function, thus hindering the delivery of food and industrial supplies in various cities and foreign trade. Numerous production processes were affected, and prices rose. Moreover, the third outbreak of the pandemic worsened with a significant increase in the number of cases and deaths. All of this was reflected in a slowdown in economic activity in May, which the EMI estimated at -5.8% compared to April and which also lowered the annual growth of the economy to 13.4% compared to 29.3% in April.

Once the most critical moment in terms of public order was over and the productive sectors reopened, GDP was expected to resume its growth trend in the second half of the year. The recovery in consumer and business confidence (which began to be seen in the June surveys) and the progress made on the vaccination plan will probably help reinforce domestic demand with a recovery in consumption and investment. In addition, a boost is expected from higher crude oil prices and substantial public sector infrastructure efforts. Expansionary monetary policy, favorable domestic credit conditions and government support for household and company income are likely to support this trend. Demand from abroad is also expected to recover further, spurred by our trading partners' stronger growth and the improved terms of trade. These factors and the positive results in the first quarter led the technical staff to revise the projected growth of the GDP upward for 2021 to 7.5%, although this is subject to the risks mentioned above.

Employment

In the first half of 2021, the employment recovery slowed down, and unemployment rates remained at particularly high levels. This, in part, can be explained by the emergence of new waves of Covid-19 infection, which made it necessary to resort to mobility restriction measures and accentuated citizens' fear of resuming their everyday activities. This was compounded by the blockades and public order disruptions, which affected the recovery of productive activity and job creation. With all this, the number of people employed in the national total as of May was 1.3% lower (272,000 jobs) than the levels in December 2020 while, in the thirteen cities, the number of jobs was relatively similar. These figures mean that, as of May, only 72% (about 4.2 million) of the jobs lost since the beginning of the pandemic had been recovered.

In recent months, there was also a slowdown in the growth rate of non-wage and informal work, leading to the recovery of urban employment in the second half of 2020. In contrast, the salaried and formal segments of the labor market remained on an upward trend. Despite that, based on numbers as of May 2021,[1] the salaried segment continued to show a smaller recovery concerning the number of jobs lost since the pandemic started (64.7%) when compared to the non-salaried segment (79.2%). A similar trend was seen when urban employment was broken down into formal and informal segments. In this case, despite having recovered a smaller proportion of jobs lost, the formal segment has been stronger in recent months. The gradual recovery of formal employment is also confirmed by administrative records such as the integrated pension contribution form (PILA in Spanish), which has shown a progressive increase in pension contributors as of April.

The peaks of the pandemic also implied a decrease in labor supply. However, due to the major drop in employment, unemployment rates stopped falling and even registered slight increases. Thus, the seasonally adjusted monthly national unemployment rate stood at 15.2% in May. In other words, it was 0.8 pp above what it registered last December, while the urban unemployment rate remained unchanged at 16.5%. Given the projections for economic activity, the national unemployment rate is expected to continue declining very gradually.

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1 After this Report had been published, employment data for June 2021 became available, but not in that edition.

Inflation and Monetary Policy

The inflation rate closed at 1.61%, below the target of 3.0% in 2020 and more than 50% below the inflation registered in 2019 (3.8%). The downward pressure that dominated the inflation trajectory throughout last year resulted from the fall in aggregate demand, the excess productive capacity, the low pass-through of the currency depreciation to the prices, and the effect of temporary tax and tariff relief. Annual inflation continued to decline until it hit 1.51% at the end of March because the excess productive capacity and other bearish factors remained in place despite of the rebound in economic growth during the first quarter.

This trend reversed itself in the second quarter and, in June, ended with annual inflation of 3.63%, which exceeds the inflation target. This change in the inflationary trend is, as expected, partly explained by the low baseline for comparison in the second quarter of 2020. However, other factors that came into play made this reversal more pronounced than expected. These resulted from the road blockades, which caused a significant increase in the prices of perishable foods because of supply difficulties in several cities, in addition to the upward pressure on animal protein prices due to increases in production costs and reductions in supply. Moreover, the rise in the international prices for commodities and raw materials due to difficulties in global supply chains and logistical problems in transportation accentuated the upward pressure on prices. The annual change in the group of regulated items also surged because of the partial removal of the relief for the costs of utilities granted in 2020 and the increase in the price of fuel under pressure from the rising international prices for crude oil.

Core inflation, measured as annual inflation excluding food and regulated products, followed a pattern similar to headline inflation, although considerably less pronounced. After ending 2020 at a level of 1.11%, it continued to decline and went to 0.94% yearly in March, then rebounded to reach 1.87% in June. Although some components of the core basket were affected by the same factors that influenced headline inflation, its greater stability is a result of the fact that this measurement of inflation excludes food and regulated items that are the segments where upward pressure on prices is concentrated. This pressure did not come from excess demand, but supply shortages since excess productive capacity persist in the economy. This was particularly clear in the case of perishable food because of the supply difficulties in the middle of the roadblocks.

The nature of the supply shock as the source of the recent inflationary pressure was a key factor that the monetary authority considered when they kept the interest rate unchanged at the June meeting even though headline inflation was above the target. This was because supply shocks are usually transient and are not solved by interest rate increases but by restoring supply conditions. That happened in June when most of the roadblocks were lifted and deliveries to the major cities could go back to normal. As a result, annual inflation for perishable food registered a significant drop from its peak of 18.16% in May to 8.69% in June.

However, some of the inflationary pressure that occurred in May could persist due to the time required to restore the productive processes that were affected by the roadblocks as well as the rises in international food prices and high logistical and transportation costs. The possible passthrough of accumulated depreciation of the peso to the tradable component of consumer prices could be added to this. Inflation expectations, which remain at around the target, could come under upward pressure. With this in mind, the technical staff estimates that headline inflation will probably remain above 3.0% for the remainder of the year and return to its convergence toward the target in 2022. As is well known, under the inflation targeting plan, the trend of both inflation expectations and that of other macroeconomic variables are basic input for monetary policy decisions in the context of high uncertainty caused by the pandemic that Colombia and the world are still facing.

Balance of Payments

At the close of the first quarter, the current account deficit of the balance of payments came to USD 3.63 billion (b), which is USD 1.09 b higher than the one during the same period in 2020. As a share of the quarterly GDP, that deficit was 4.8% and 1.3 pp greater than the one a year ago. The rise in the current deficit results from the greater imbalance in trade in goods and services and, to a lesser extent, the increase in the net outflow of factor income. These results were partially offset by the better net income from current transfers and occurred in an environment where the private sector's saving-investment balance continues to be a surplus.

The larger trade deficit in goods was due to a decline in earnings from merchandise exports and an increase in imports. With respect to exports, sales abroad of coal, petroleum, and bananas fell while industrial products, gold, coffee, and flowers rose. The lower value of crude oil and coal exported was due to the drop in the volume exported and partially offset by the increase in export prices. Regarding gold and coffee exports, the increase was due to the rise in the quantities shipped and the sales prices. The increase in the imported value of merchandise, in turn, resulted mainly from the higher purchases from abroad of supplies and capital goods for industry and consumer goods. The deficit in the balance of services also rose due to the lower sales of the traditional ones such as trips and transportation that have not been offset by higher exports of modern services associated with the use of information and communication technologies.

At the end of the first quarter, the factor income deficit rose USD 474 m, mainly due to higher outflows of foreign direct investment (FDI) earnings. Income associated with portfolio investments and interest payments on foreign loans increased as well. There was an overall increase in FDI profits with higher profits for companies operating in oil drilling; manufacturing industries, electricity, gas, and water supply; and trade, restaurants, and hotels.

Last of all, there was a USD 332 m improvement in the positive balance of the current transfers in the first quarter compared to the same period in 2020. The higher income from workers' remittances significantly impacted this with an annual rise of 10.2% (USD 179 m). This income is equivalent to 2.6% of the quarterly GDP and 13.3% of the current income from the balance of payments. The remittances from the United States and Spain stood out the most as they went from 14% to 30% per annum, while those from countries in Latin America declined 6.0%.

The changes described in the current account balance are related to changes in the environment abroad and domestic economic activity in the context of the pandemic. On one hand, the increase in the prices of various export products and the reactivation of developed economies were reflected in higher terms of trade and contributed to the rise in workers' remittances sent to this country. On the other, the economic recovery in the first quarter led to a higher demand for imports and an increase in the remittance abroad of profits of companies in Colombia with FDI. Some export sectors could not fully respond to the stimulus of the higher terms of trade due to the impact of the pandemic on their productive processes.

The financial account of the balance of payments depends on capital markets, and these reflect the interest rates and risk perceptions along with other factors. During the first quarter of 2021, net capital inflows were estimated at USD 3.16 billion (4.2% of the quarterly GDP), which is USD 996 m higher than what was seen a year ago. FDI flows, totaling USD 2.70 billion (3.6% of the quarterly GDP), stood out among the sources of financing. One-third of these funds went to mining and crude oil while the transportation, communication, and financial and business service sectors received 40% of these flows. Another important component of foreign financing was the net liquidation of USD 2.38 billion in Colombian capital abroad, mainly due to the decrease in the financial assets held by public sector entities. During this period, the gross foreign reserves rose USD 190 m resulting from USD 199 m in interest income and net expenditures of USD 9 m on other *Banco de la República* operations.

On May 19, Standard & Poor's risk rating agency downgraded Colombia's long-term public debt credit rating to below investment grade. Fitch Ratings made the same decision on July 1. The rating agencies highlighted the deterioration of the country's fiscal situation as a determining factor in this decision. Nevertheless, both agencies are holding to a stable outlook, thus providing a waiting period for economic recovery and announced fiscal reform to stabilize the country's debt burden. The immediate impact of this decision on the financial and exchange rate markets was moderate since it had been expected since January when the TES rates rose.

The technical staff estimates that the current account deficit in 2021 will probably reach 4.5% of GDP, which is higher than the 3.4% deficit seen in 2020. This is consistent with the recovery of the Colombian economy this year despite the expectations of increasing revenue due to the better growth of our trading partners, terms of trade, and remittances.

Public Finances

The monetary authority closely monitors the state of and prospects for public finances to ensure proper coordination between the monetary and fiscal policies and contribute to the design of a macroeconomic policy that fosters the stability and economic growth of the country.

In Colombia, as in many countries, the Covid-19 pandemic led to a sharp deterioration in public finances. That was how the central national government's (CNG) deficit went from 2.5% to 7.8% of the GDP between 2019 and 2020 and the public debt as a share of the output rose 14.5 pp over the course of 2020 and reached a level of 64.8% of the GDP. Part of this deterioration resulted from the sharp drop of COP 17.7 trillion in the CNG tax revenue in comparison to 2019 as a consequence of the downturn in economic activity. Added to this was the COP 21 trillion increase in expenditures to deal with the emergency and the COP 8 trillion rise in pension transfers.

The CNG will continue implementing the Emergency Mitigation Fund (FOME in Spanish) funds to help alleviate the impact of the pandemic in 2021. The main uses have been for household and business assistance programs and the purchase of Covid-19 vaccines. Among these subsidies, the most notable are the Solidarity Income program which grants COP 160,000 per month to close to three million households, and the Formal Employment Support Program (PAEF), through which the CNG provides applicant companies with a payroll subsidy equivalent to 40% of the minimum wage (COP 351,000) per employee and which has helped to preserve close to four million jobs. The Debtor Assistance Program (PAD) has been another important support that seeks to help debtors who need to normalize their financial obligations to recover. In developing PAD, more than 2.2 million debtors had had the terms of their loans redefined to the tune of COP 36.1 trillion by the end of May. According to the Office of the Financial Superintendent of Colombia, 90.3% of the portfolio covered by PAD has succeeded in keeping up with their payments. Given the lengthening of the emergency, CNG announced that these programs would be extended.

Although the Medium-Term Fiscal Framework anticipates that total CNG revenue, including the privatizations, will recover to 1.0% of the GDP in 2021 and return to the same level as in 2019 (16.2% of the GDP), the CNG deficit is likely to go to 8.6% of the GDP this year which is 0.8 pp higher than the one in 2020. This was because of the higher spending pressure associated with the health emergency, the increase in interest resulting from the rising debt, and the larger public investment proposed by the CNG to help reactivate the economy. This could bring the CNG's gross debt to 66.8% of GDP at the end of this year.

This scenario involves the need to approve a fiscal reform that will make it possible to channel public finances towards a sustainable path in the medium term. As the BDBR has reiterated, the ability of monetary policy to pursue an expansionary stance may be jeopardized if no progress is made in this direction.

Foreign Reserves

At the close of June 2021, the net foreign reserves totaled USD 58.917,3 million and were USD 113.4 m lower than the end of the previous year. In line with what was expected, this result is explained by a considerably lower profitability than obtained in 2019 and 2020. Indeed, over the course of the year, the return on the foreign reserves was -0.01% (USD 4.18 m) due to the low short-term interest rates in the foreign financial markets and the devalued investments resulting from the increase in medium- and long-term interest rates. For the second half of 2021, the return on foreign reserves is expected to remain low. With interest rates in the markets where the reserves are invested at near-zero levels, the interest received will be very low, and there is no prospect of appreciations from additional rate reductions in the short term.

The indicators for evaluating the foreign reserves show appropriate levels for the country. The IMF has proposed a methodology (ARA) for an appropriate level of reserves that seeks to cover the main risks to the balance of payments by considering macroeconomic variables[2] during periods when there is pressure on the exchange market. An economy is believed to be maintaining proper reserves if the ratio of the reserves to the appropriate level is between 1.0 and 1.5. Based on figures as of June 2021, the ratio of IMF reserves to the appropriate level stood at 1.5.[3]

To estimate foreign currency liquidity needs in an adverse scenario over a one-year horizon, *Banco de la República* follows the liquidity coverage ratio approach (LCR). This approach stipulates that the liquid assets should be sufficient to cover liquidity needs for a predetermined period while considering the stressed scenario. *Banco de la República*'s methodology stipulates that the foreign reserves should cover the forecasts for the current account deficit for the next twelve

2 This acronym corresponds to *assessing reserve adequacy.*

3 The calculation was done with the IMF's ARA methodology and figures from *Banco de la República*.

months at least plus the repayment of foreign debt.[4] As of June 2021, the foreign reserves covered these items. The methodology also determines that the sum of the foreign reserves and FCL should cover the above items plus the possible outflows of residents' and non-residents' capital. The foreign reserves plus the IMF's net FCL disbursements are currently higher than that level.

Banco de la República's Profits

In the first half of 2021, *Banco de la República* registered a profit of COP 524 billion, contrasting with the exceptionally high results registered during the same periods in 2019 and 2020. The above is mainly due to the lower return on the foreign reserves that resulted from the low foreign interest rates.

To the degree that foreign interest rates are at near-zero levels, there are no prospects for reductions that could be reflected in appreciations of the foreign reserve portfolio. As a result of the above, the Bank is expected to generate losses in 2021 due to the negative returns of the foreign reserves. Therefore, these are *Banco de la República*'s main asset and are decisive on its income statement.

4 For more information on the methodology, see the shaded section: new methodology for determining the appropriate level of foreign reserves in the March 2019 Board of Directors' Report to the Congress of the Republic.

02 / Macroeconomic Environment and *Banco de la República*'s Response

In the first few months of the year, economic activity continued to recover at a faster than expected pace. This trend was interrupted by the adverse effect of the third wave of Covid-19 on output and the roadblocks during the protests in the second quarter. The improvement in the terms of trade, the ample international financing, the recovery of demand from abroad, and low interest rates continued to stimulate the country's economic growth. Supply constraints, disruptions in global value chains, and the winding down of various price reductions granted in 2020 helped to temporarily drive inflation to a rate that is somewhat above the target. However, inflation is expected to resume its convergence with 3.0% in 2022 in an environment of excess productive capacity that remains extensive. This context of actual and expected close-to-the-target inflation has made it possible to continue the expansionary monetary policy that will help drive output and employment to their long-term levels.

During 2020, the Bank's actions were geared towards ensuring the proper functioning of the payment system, maintaining the supply of credit, contributing to the stability of key markets, and supporting the reactivation of economic activity. As of March 2020, policies were adopted that succeeded in preventing a serious crisis in the midst of the pandemic. The Bank reacted in a timely and decisive fashion to address the unprecedented shocks generated by the health crisis by providing ample liquidity in pesos and dollars and reducing their policy interest rate. The Bank's reaction to the imminent effects of the crisis was carried out on two fronts: the first was to take immediate action by setting up measures that provided liquidity to stabilize markets that were showing signs of risk because of the sudden change in global macroeconomic and financial conditions; the second was gradual action that sought to mitigate the effects of the pandemic on economic activity and to support recovery as the markets began stabilizing. This was to protect the payment system and stabilize key markets that were under pressure in the short term, and protect the supply of credit, reduce the financial burden on households and businesses, and stimulate economic activity in the medium and long term. Specifically, the policy actions of the Bank included: 1) the extension of repo operations; 2) purchases of financial instruments; 3) the reduction in reserve requirements; 4) the provision of hedging mechanisms and liquidity in dollars; 5) the reduction in the monetary policy interest rate, and 6) maintaining a sound international liquidity position.

So far in 2021, the Bank has maintained an expansionary monetary policy stance with a policy interest rate at historically low levels (nominal and real). The BDBR decided to reduce the monetary policy interest rate 250 basis points (bp) over the course of 2020 going from 4.25% at the beginning of the year to 1.75% in September. This was in response to the negative effects on output and the use of the necessary measures to control the pandemic. Indeed, in the second quarter of 2020, output registered a sharp drop and even though it recovered in the second half of the year, it did not reach pre-pandemic levels. The economy registered ample excess capacity. The labor market deteriorated significantly, and inflation presented a persistent downward trend and closed the year at 1.61% which is below the Bank's target. Over the course of 2021, the persistence of a large excess productive capacity as well as headline inflation and inflation expectations close to the target have made it possible to keep the policy interest rate at historically low levels. This expansionary monetary policy stance helps drive employment and output to their long-term levels. Going forward, the degree of monetary policy expansion will be determined by the performance of inflation and inflation expectations with respect to the target, by the changes in excess productive capacity and the labor market, by foreign and domestic financial conditions, the progress in the fiscal adjustment the country needs, and the economic situation in general.

The Bank's actions helped to alleviate the initial pressure observed in the public and private debt markets in the first few months of the crisis while, at the same time, they accommodated the intense preference for liquidity in the economy by supplying abundant funds using several mechanisms. Thus, during 2020, the amounts, eligible counterparties, maturities, and eligible securities of the Bank's repo operations were extended. Purchases of public and private debt securities were implemented, and reserve requirements were lowered 2 percentage points (pp) on average as a means of permanently freeing up funds for the economy and to reinforce incentives for financial intermediation. This set of measures made it possible to ensure that the payment system functioned properly and provided a necessary means of maintaining or expanding the supply of credit. The purchases of TES and private debt securities helped stabilize these markets that had been hard hit by the shocks resulting from the pandemic. This was key to preventing major disruptions in the financial system interest rates and in the corporate bonds market. In addition, the aggregate growth of the portfolio was enhanced through the addition of private debt securities to the repo portfolio. In general, the effects of these measures were perceived in the more than sufficient liquidity in the financial system. Over the course of 2021, the Bank has continued to provide the liquidity that the economy has required in accordance with its goal of ensuring that the overnight banking benchmark indicator (BBI) is close to the monetary policy interest rate set by the BDBR.

The foreign exchange hedging and dollar liquidity mechanisms granted by *Banco de la República* contributed to stabilizing the foreign exchange market. The FCL and the possibility of accessing repos with the Federal Reserve through FIMA also contributed to this. Measures were adopted in 2020 to reduce pressure on the foreign exchange market with intervention mechanisms that facilitated hedging and expanded liquidity in dollars without affecting foreign reserves. These mechanisms were: 1) forward sales of dollars with financial settlement at one month to extend hedging against the risk of a sharp depreciation of the peso, and 2) dollar *swaps* at two-months to stabilize the foreign exchange market and provide liquidity in dollars. The improvement in the financial and external liquidity conditions together with the Bank's timely reaction made the adjustment of the foreign exchange market and gradual decreases in the risk perception possible in the second half of 2020. The demand for the temporary dollar liquidity granted by the Bank through these mechanisms was gradually reduced until renewal of these contracts was no longer needed. In fact, the last USD 90.9 m *in forwards* expired at the beginning of March 2021 and were not rolled over by the market. The measures adopted to preserve a solid international liquidity position also contributed to the stabilization of the foreign exchange market. These measures included: 1) IMF approval of the USD 17.2 billion increase in the FCL[5] for Colombia in September 2020[6] that was in effect through April 2022 and provides greater flexibility to cover the

5 In April this year, the Board of Directors of the Fund did an interim evaluation of our country and confirmed that Colombia continues to meet the conditions for access to this instrument.

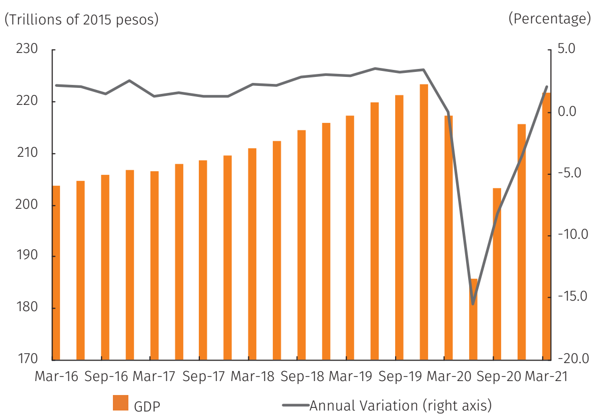
6 This figure includes the disbursement to the national government of approximately USD 5.4 billion for budgetary purposes in December 2020.

financing needs abroad in high-uncertainty environments; and 2) the access to the repo facility (FIMA) that the Federal Reserve offers which allows the country to have liquidity in US dollars if needed without having to face adverse market conditions nor sell off the assets of the foreign reserve portfolios permanently. This mitigates liquidity and market risks. Another factor of global support that may improve the country's international position is the proposed allocation of the IMF's Special Drawing Rights (SDR) that was recently approved by the Fund's Board of Directors and will be ratified in August of this year by the IMF's Board of Governors.

2.1 Performance and Outlook for the Economy and Labor Market

2.1.1 Economic Activity

Graph 2.1
Gross Domestic Product[a/]
(quarterly and annual change)



a/ Seasonally adjusted series and corrected for calendar effects
Source: DANE, calculations by *Banco de la República.*

In the first four months of the present year, economic activity was recovering at a faster pace than anticipated at the beginning of 2021. However, the roadblocks, strike, and damage to urban infrastructure in May and June and, to a lesser degree, a third peak of the pandemic temporarily interrupted this trend. In the first quarter of 2021, GDP grew at an annual rate of 2.0%[7] (seasonally adjusted series and adjusted for calendar effects) which was higher than *Banco de la República's* technical staff had expected (Graph 2.1). The positive economic performance weakened in April due to the third wave of the pandemic, self-protection and distancing measures, and the restrictions on movement adopted in several cities. This was suggested by the economic monitoring indicator (EMI) for that month, and the commerce, transportation, and lodging sectors were the most affected. There was a significant decline in the EMI in May (-5.8% compared to what was registered in April) which could be attributed in large part to the road blockages and disturbances in public order as well as the pandemic. These developments will probably lead to a decrease in the GDP level between the first and second quarter of 2021.

The recovery of economic activity in the first quarter of the year was remarkable since it pushed quarterly GDP to levels very close to those registered prior to the pandemic. The continual opening up of various sectors, the better performance of our trading partners, the countercyclical fiscal measures, and expansionary monetary policy all contributed to this new improvement in the economy. During this period, many of the branches of economic activity recovered to the levels they were at before the pandemic, especially the tertiary branches, among which commerce and repair segment exceeded the pre-pandemic levels. The aggregate value for the manufacturing industry likewise registered the highest annual growth among the major

7 In original series, it was 1.1%.

branches of the economy (8.4%). Nonetheless, construction, transportation, warehousing, mining, and the lodging and food services group continued to lag (Table 2.1).

The better performance in output in the first quarter was due to the reactivation of domestic demand, with private consumption and housing investment playing a predominant role. During this period, domestic demand started to show positive annual growth rates again (1.6%) after three consecutive quarters of annual setbacks (Table 2.2) even though its level remained below the values registered before the pandemic. There were notable quarterly recoveries in both total consumption and gross capital formation, although their annual changes were still low, 1.2% and 1.0% respectively. Household consumption, which had an annual expansion of 1.0%, was once again driven by the opening up of trade and the easing of restrictions on movement. Public consumption, in turn, continued to play a major countercyclical role, with an annual change (5.1%) higher than GDP growth. Finally, within the gross fixed capital formation, the most notable recovery was that of investment in housing, which went from falling 14.7% yearly in the fourth quarter last year to falling 3.4% in the first one of 2021.

For the first time since the start of the pandemic, real exports contributed significantly to the quarterly recovery of economic activity in the first quarter. However, their levels continued to be below pre-pandemic records. The

Table 2.1
Real Annual GDP Growth by Branch of Economic Activity
(seasonally adjusted and corrected for calendar effects, base 2015)

	2020				2020	2021
	Q1	Q2	Q3	Q4	Full year	Q1
Agri-business, Forestry, Hunting, and Fishing	5.5	0.5	2.3	2.1	2.6	3.4
Mining and Quarrying	-3.4	-20.8	-19.6	-20.5	-16.0	-14.6
Manufacturing Industry	-1.5	-23.8	-5.6	0.1	-7.7	8.4
Electricity, Gas, and Water	3.3	-8.5	-4.2	-0.9	-2.6	-1.3
Construction	-15.3	-36.7	-26.7	-24.8	-25.8	-5.3
Buildings	-18.9	-31.9	-26.8	-20.0	-24.4	-3.0
Public works	-11.0	-47.6	-29.4	-26.6	-28.4	-11.4
Specialized Construction Work	-17.9	-37.2	-25.4	-20.9	-25.2	-5.9
Commerce, Repairs, Transportation, and Accommodations	1.2	-34.0	-21.1	-6.5	-15.2	-0.7
Information and Communications	0.5	-5.1	-1.8	-3.8	-2.6	2.2
Financial and Insurance Business	2.5	1.2	1.7	3.2	2.1	4.8
Real estate	2.5	1.7	1.8	1.7	1.9	1.7
Professional, Scientific, and Technical Work	2.0	-10.6	-5.9	-2.6	-4.3	1.3
Public administration and Defense, Education, and Health	1.3	-1.6	0.6	2.6	0.7	3.6
Artistic, Entertainment, and Recreational Activities	5.8	-33.5	-11.5	-6.0	-11.5	7.7
Subtotal value added	0.8	-15.7	-8.5	-4.0	-6.9	0.8
Taxes minus subsidies	0.7	-13.9	-8.0	-2.9	-6.0	1.9
GDP	0.0	-15.5	-8.2	-3.4	-6.8	2.0

Source: DANE, calculations by *Banco de la República*

Table 2.2
Real Annual Growth of the GDP by Type of Expenditure
(seasonally adjusted and corrected for calendar effects, base 2015)

	2020				2020	2021
	Q1	Q2	Q3	Q4	Full year	Q1
Final spending on consumption	3.8	-11.6	-7.4	-0.2	-3.9	1.2
Final spending on household consumption	3.9	-15.0	-9.7	-1.5	-5.6	1.0
Non-durable Goods	14.0	5.6	1.0	5.6	6.5	0.9
Semi-durable Goods	-1.3	-40.8	-20.9	-3.5	-16.6	10.6
Durable Goods	4.0	-31.1	-0.4	10.4	-4.2	12.4
Services	-0.3	-19.5	-13.6	-6.0	-9.9	0.1
Final spending on general government consumption	3.2	3.3	3.5	4.6	3.7	5.1
Gross Capital Formation	-7.1	-37.7	-15.9	-20.9	-20.3	1.0
Gross Fixed Capital Formation	-5.1	-39.4	-23.2	-14.7	-20.6	-3.4
Housing	-9.6	-42.6	-33.6	-24.4	-27.5	-3.2
Other buildings and structures	-7.7	-42.2	-35.2	-28.1	-28.3	-20.6
Machinery and Equipment	-1.0	-36.7	-5.4	4.5	-10.3	8.5
Cultivated biological resources	2.4	1.2	-5.0	1.8	0.0	9.8
Intellectual property products	1.0	-15.0	-9.1	-5.8	-7.2	1.3
Domestic demand	0.4	-16.6	-8.7	-3.9	-7.2	1.6
Exports	-3.6	-26.1	-23.3	-20.4	-18.3	-8.9
Imports	0.6	-30.8	-23.8	-14.6	-17.3	-4.9
GDP	0.0	-15.5	-8.2	-3.4	-6.8	2.0

Source: DANE; calculations by *Banco de la República.*

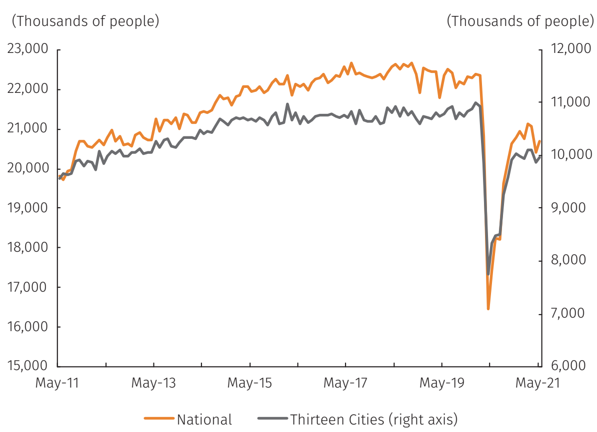
annual change in this component (-8.9%) in the first quarter was a significant improvement compared to the drops during the previous three quarters, all of which had been greater than 20% (in absolute terms). The positive performance of exports during this period was mainly due to sales of coffee, nickel-iron (helped by a very low base of comparison), some manufactured goods, and services. Imports, in turn, registered a yearly decline (-4.9%) that was considerably smaller than those in previous quarters. The purchases of capital goods and some raw materials were the primary contributors to this.

A decline in GDP levels is expected for the second quarter because of the effects of the road blockades, and the third Covid-19 peak. Even though all major components of demand probably registered significant annual growth in the second quarter because of the low bases of comparison, the roadblocks and infrastructure destruction during the protests together with the third peak of the pandemic (which started in April) probably had a strong effect on its performance. The available indicators suggest setbacks in the levels of all the major expenditure items due to these events. Particularly, domestic demand will probably be at values similar to those in the fourth quarter of 2020 as a result of the quarter-on-quarter decreases in consumption and gross capital formation. The available figures on foreign trade, in turn, suggest that exports could register declines while imports will probably remain at levels close to those in the first quarter. By branches of activity, the forecast anticipates large quarterly declines in land transportation, vehicle trade and maintenance, manufacturing industry, and the sectors of livestock and other crops.

Going into the third quarter and what remains of the year, the GDP should resume an upward trend and thus recover its cumulative pre-pandemic annual levels[8] between the end of 2021 and the beginning of 2022. The technical staff's forecast assumes that the public order disturbances and road blockades that affected growth during the second quarter are not likely to be repeated for what remains of the year nor will there be new restrictions on mobility as a result of the pandemic. This would result in economic activity resuming in the second half of 2021 the growth momentum it had in the first quarter due to more productive activities opening up and a recovery of consumer and business confidence. This could contribute to a resumption of the positive performance of domestic demand with recoveries in consumption and investment. Furthermore, regarding the latter component, an additional boost is expected from higher crude oil prices and the implementation of the public sector reactivation plan for housing and infrastructure. A monetary policy that will probably remain expansionary, favorable domestic lending conditions, a fiscal stimulus that continues to support household and business income could also encourage this trend. Demand from abroad will probably continue to recover hand in hand with our trading partners' stronger growth and the improved terms of trade. These factors and the better results in the first quarter led the technical staff to revise the projected growth of the GDP upward for 2021 to 7.5%. The estimated growth figure for 2022 is at around 3.0%. The forecast for the economy in both the short and medium term is still facing significant sources of uncertainty. The most relevant ones are the changes in the pandemic, the progress in the fiscal adjustment required for the country, and the changes in international financial conditions.

2.1.2. Labor Market[9]

Graph 2.2
Employed Population by Geographic Domain
(seasonally adjusted monthly)



Source: DANE (GEIH), calculations by *Banco de la República*.

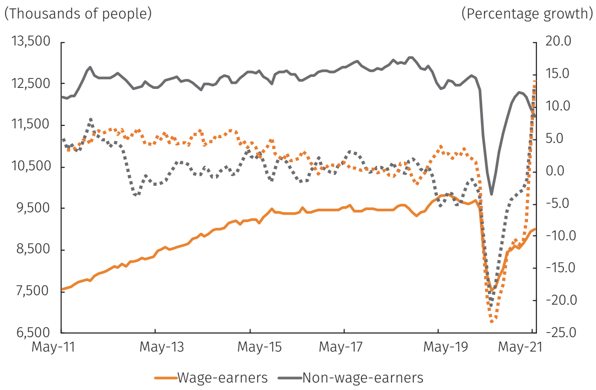
Job recovery was halted in the first few months of 2021, in part, by the waves of Covid-19 that led to both the implementation of restrictions on movement in various cities and self-protection by individuals as well as by the disruptions in public order in the country. The seasonally adjusted monthly figures from the General Integrated Household Survey (GEIH) show a labor market that continues to deteriorate, even in the first half of 2021, slowed down its pace of recovery (Graph 2.2). The second wave of Covid-19 infections and the restriction measures

8 Cumulative GDP for the last four quarters.

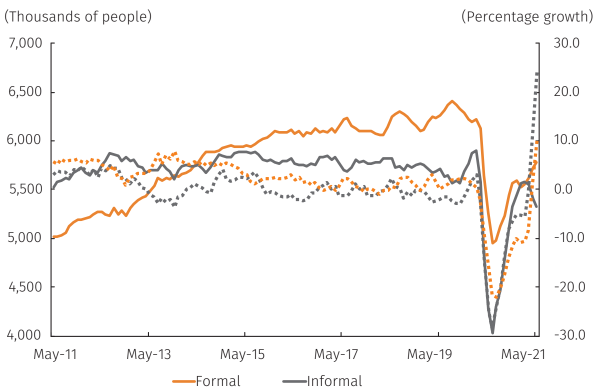
9 The labor market figures are showing a seasonal adjustment i.e., their numbers are systematically higher or lower depending on the month of the year. This phenomenon has to be identified through statistical techniques in order to compare different months of the same year. That is why the information given in this section corresponds to the series that does not have such calendar effects which is called the seasonally adjusted series.

Graph 2.3
Employed by Type of Job
(seasonally adjusted quarterly moving average)

A. Wage Earners and Non-wage Earners: National Total

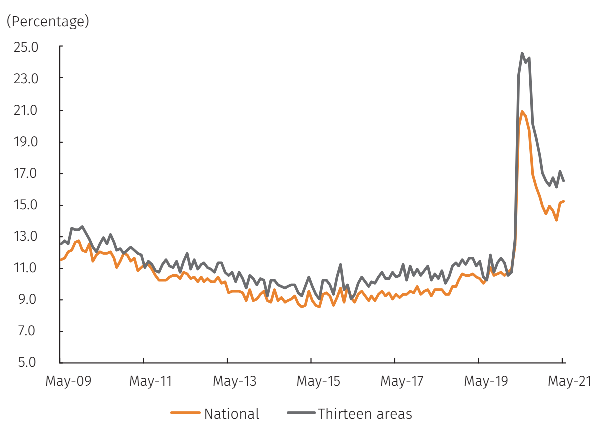


B. Formal and Informal: Twenty-three Cities and Metropolitan Areas



Notes: the dotted lines correspond to annual growth (right axis).
The National Bureau of Statistics (DANE) officially considers the workers who work in establishments, businesses, or companies that employ up to five people in all their agencies and branches, including the employer and/or partner to be informal and excludes from this self-employed professionals and government workers and employees.
Source: DANE (GEIH), calculations by *Banco de la República*.

Graph 2.4
Unemployment Rate by Domain
(seasonally adjusted monthly)



Source: DANE (GEIH), calculations by *Banco de la República*.

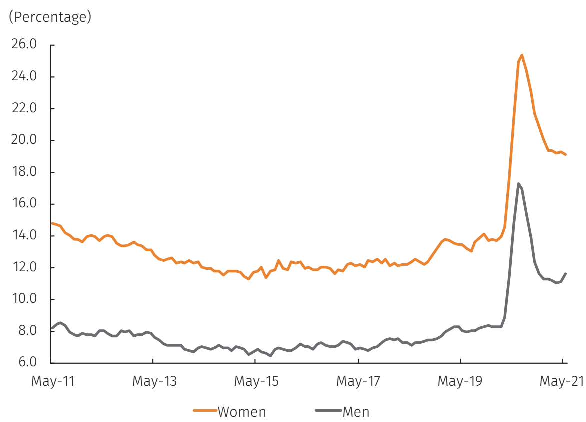
on movement implemented in January led to a monthly drop in the number of employees both nationally and in the thirteen main cities. Although the recovery resumed in February, a third wave of infections led to a further sharp decline in employment in April. The fact that this new wave of infections became more prolonged in May and the problem with road blockades and public order once again limited the recovery in the number of people employed. Because of all of this, the number of employees in May in the national total did not exceed the levels in December 2020 (compared to this month, it was 1.3% lower; in other words, 272,000 jobs) while, in the thirteen cities, the number of jobs was relatively similar to that at the end of 2020. These figures mean that there were still 1.7 million jobs that needed to be recovered as of May out of the 5.9 million lost at the beginning of the pandemic.

Although the non-salaried and informal segments had led in job recovery, their rate of growth has declined in recent months. The salaried and formal workers, in turn, have remained on a growing trend. The recovery in employment seen during the second half of 2020 was characterized by having been driven, largely, by the segments with lower income stability – the non-salaried-earning and informal sectors. Nevertheless, these segments have become less important as drivers of growth in the number of employees in the last few months. With respect to the national total, even though the salaried segment has recovered 64.7% of the employment lost at the beginning of the pandemic and the non-salaried segment has recovered 79.2%, the salaried employment is still on an upward trend while the non-salaried has begun to stagnate (Graph 2.3, panel A). When urban employment is broken down into formal and informal segments, it shows the same performance as is seen in the case of the recent salaried employment (Graph 2.3, panel B). Here, the formal segment, although still at lower levels than those seen in the pre-pandemic period, has shown a better performance than its informal counterpart has in recent months. The gradual recovery of formal employment has also been confirmed by information from administrative records such as the integrated pension contribution form (PILA) that shows a progressive increase in pension contributors who are salaried workers as of April.

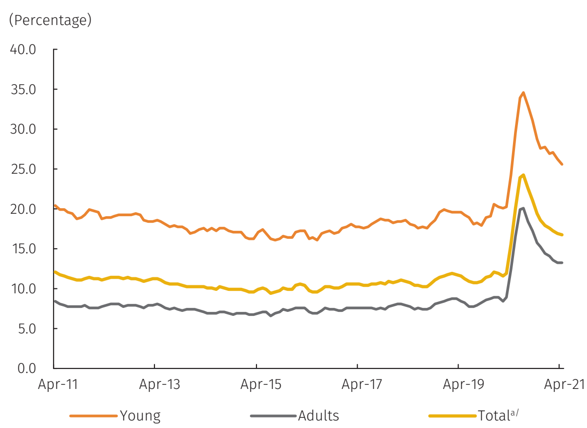
The peaks of the pandemic also implied a decrease in labor supply. However, since the drop in employment was even larger, unemployment rates stopped falling and even registered slight increases. The measures to restrict mobility and self-protection, adopted as a result of the waves of contagion, as well as the restrictions caused by road blockades and public order disturbances imply that inactivity stood at 2.3% (366,000 couldn’t work) in May. These levels were higher than the registered in December in the national total while, in the urban areas, such increase was 1.4% (93,000 unable to work). This labor supply situation partially offset the lower labor demand, which meant that, in the first half of 2021, unemployment rates (TD) were

Graph 2.5
Unemployment Rate by Population Groups
(seasonally adjusted quarterly moving average)

A. By Gender: National Total



B. By Age: Twenty-three Cities and Metropolitan Areas



a/ For people over 14 years of age.
Source: DANE (GEIH), calculations by *Banco de la República*.

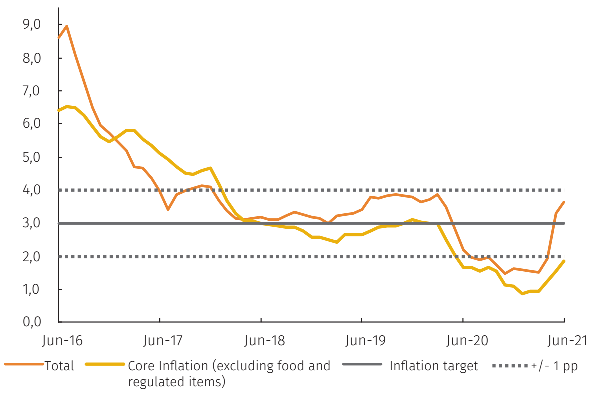
relatively stable with increases in the national total in April and May that reversed the setbacks in the first few months of the year. Thus, the seasonally adjusted monthly national UR stood at 15.2% in May, 0.8 pp higher than last December (Graph 2.4), while the urban UR remained unaltered at 16.5% compared to the same month. Nevertheless, significantly high UR levels are still being registered (4.3 pp and 5.9 pp above the pre-pandemic record for the national and the thirteen cities UR respectively) with rates of decrease that have slowed down considerably in recent months.

Significant disparities between population groups persist. With regard to unemployment, this has affected women and young people the most. Although the Colombian labor market has shown a correction with respect to the deterioration seen at the beginning of the pandemic, the different population groups still show a heterogeneous behavior. In the case of gender, the gradual recovery of productive activities has been led by sectors that employ a larger percentage of men due to which the recovery of employment has been slower for women. That said, the existing restrictions on the return to face-to-face teaching at educational institutions, along with other factors, has affected women's employment. As a result, women's UR is still at substantially high levels (Graph 2.5, panel A), and this suggests a gender gap in unemployment that remains quite large (7.5 pp in the quarterly moving average as of May). Significant differences between age groups also persist. The health crisis caused a greater increase in unemployment for young people (up to 28 years of age) than for people at other ages (Graph 2.5, panel B). Despite a certain correction in recent months, this gap has been maintained, especially due to the greater labor participation of young people not attending the educational system, which has not been accompanied by similar increases in employment.

Given the recent trends in the labor market and forecasts for economic activity, a moderate reduction in the UR is expected for the remainder of 2021. In spite of the recent performance of the UR, the most recent information available on indicators of job openings that are calculated on the basis of GEIH and the Public Employment Service (PES) show a rebound in the last few months even though the levels are still below those from the pre-pandemic period. Monthly labor income from the GEIH also show a gradual recovery in the income of non-salaried earners through an increase in hours worked while those who have wage-earning employment remain relatively stable. This suggests that even though the labor market remained loose in the first half of 2021, going forward, it could continue to recover gradually. Given recent trends and considering economic activity forecasts as well, the national UR is expected to continue to decline gradually until it stands at 13.8% towards the end of the year. Thus, it is estimated that its average level for 2021 as a whole will likely be between 13.7% and 15.0% with 14.4% being the most probable percentage. Overall, the labor market is expected to remain loose over the forecast horizon and not be a source of inflationary pressure via labor costs. Note that these forecasts fall within a context of great uncertainty since they may change depending on both the state of public order in the country and changes in the epidemiological situation along with other factors.

Graph 2.6
Headline and Core Inflation

(Percentage)



Source: DANE, calculations by *Banco de la República*

2.2 Performance and Outlook for Inflation

After the sharp drop seen last year and relative stability at the beginning of the year, annual consumer inflation showed an upward trend in the second quarter of 2021, ending in June above the target. This was the result of supply shocks, especially in food, caused by road blockades, the emergence of pressures from the international context, the gradual reduction of excess productive capacity and a low basis for comparison. Annual inflation fell to 1.61% at the end of 2020, a performance that could be attributed to the Covid-19 pandemic which weakened demand and led to the implementation of price relief policies by some local and national authorities. During the first quarter of 2021, annual inflation remained relatively stable at around 1.51% and well below the target (3.0%). However, it rebounded in the second quarter and ended in June at 3.63% (Graph 2.6). With this, from the beginning of the year to June, 3.13% in inflation had accumulated. This surge in inflation is partly explained by the road blockades in May and part of June that caused a significant increase in consumer prices, especially in the perishable food sector. It was also affected by the increase in the international prices for commodities and raw materials due to difficulties in global supply chains, logistical problems in transportation,[10] and by the recovery in global demand. This has occurred in an environment of local economic reactivation and less excess productive capacity as well as the effect of a low basis for comparison the previous year. In general, price relief,[11] which was concentrated in the second quarter of last year, generated a significant drop in most of the CPI basket (except food). This meant, twelve months later, a considerable rebound in annual consumer inflation. Some price relief measures remain in effect, and they are expected to come to an end between August 2021 and December 2022 once the indirect

10 A container shortage, rises in freight costs, restrictions on exports, etc.

11 A series of transitional relief measures on certain tariffs and prices began to be set up in March 2020. They include the COP 1,300 reduction in the price of gasoline (this decrease in fuel prices is understood as an alleviation under the assumption that the formula established to determine the price of gasoline, which limits abrupt variations in the price of fuel from one month to the next, was not in operation) and the elimination or reduction of value-added tax (VAT) to various services or goods such as low-cost mobile phone plans, hygiene and cleaning products, hotel and tourist services, and air tickets. Furthermore, rents were frozen for a few months and some local authorities established reductions, subsidies or even free utility rates. Last of all, the first VAT-free day of the three days planned for 2020 was held on June 19 last year for a selected basket of goods (clothing and shoes, appliances, sporting goods, toys and games, school supplies and agricultural goods and supplies).

taxes on eating out, hotels, tourism, and air tickets return to their pre-pandemic levels.[12]

Core inflation, understood as annual inflation excluding food and regulated items, continued declining until March 2021 (0.94%) then rose in the second quarter and reached 1.87% in June (Graph 2.6). The drop in core inflation in the first quarter of 2021 was due to the decrease in the annual change in the services component as it went from 1.29% in December 2020 to 0.89% in March and then 1.61% in June. The annual adjustment of the CPI for goods, in turn, showed an upward trend over the course of the first half of the year (0.63% in December 2020, 1.05% in March, and 2.57% in June) (Table 2.3). The upward trend of both goods and services in the second quarter of 2021 is associated with various factors. As mentioned, these CPI components accounted for a large part of the price relief granted by the various authorities in the second quarter

Table 2.3
Consumer Price and Core Inflation Indicators
(as of June 2021)

Description	New CPI weights	Dec -19	Nov -20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21
Total	100	3.80	1.49	1.61	1.60	1.56	1.51	1.95	3.30	3.63
Excluding food	84.95	3.45	1.02	1.03	0.89	0.93	1.06	1.56	2.11	2.70
Goods	18.78	2.18	0.02	0.63	0.42	1.07	1.05	1.21	1.77	2.57
Services	48.85	3.45	1.55	1.29	1.04	0.92	0.89	1.25	1.48	1.61
Rentals	25.16	2.68	1.35	1.33	1.23	1.23	1.25	1.28	1.26	1.28
FAH[a/]	8.79	4.18	3.83	3.84	3.66	3.86	4.16	4.39	5.40	6.19
Remainder[b/]	14.91	4.34	0.54	-0.26	-0.82	-1.34	-1.63	-0.66	-0.51	-0.58
Regulated items	17.32	4.81	0.58	0.73	0.94	0.83	1.52	2.79	4.21	5.93
Utilities	6.69	6.02	1.59	3.22	4.03	3.08	3.71	5.00	7.29	10.34
Fuel	2.91	1.90	-12.45	-12.22	-10.62	-9.08	-4.94	-0.32	2.73	6.64
Transportation	5.53	4.19	4.34	4.31	3.16	3.30	2.37	2.48	2.74	2.71
Education	2.38	6.38	4.73	1.05	1.05	0.56	0.67	0.70	0.70	0.70
Remainder[c/]	0.13	4.22	5.23	5.23	1.35	3.52	2.61	2.61	2.61	2.61
Food	15.05	5.80	4.09	4.80	5.51	5.02	3.92	3.98	9.52	8.52
Perishables	3.15	8.66	-1.57	2.49	6.71	6.47	1.58	1.31	18.16	8.69
Processed food	11.90	5.04	5.72	5.43	5.19	4.62	4.60	4.77	7.01	8.47
Core Inflation Indicators										
Excluding food		3.45	1.02	1.03	0.89	0.93	1.06	1.56	2.11	2.70
Core 15 (p08)		3.78	1.96	1.88	1.78	1.74	1.67	1.99	2.79	3.36
Inflation excluding food and regulated items		3.10	1.13	1.11	0.87	0.96	0.94	1.24	1.56	1.87
Average core inflation indicators		3.44	1.37	1.34	1.18	1.21	1.22	1.60	2.16	2.65

a/ Food away from home
b/ Washing and ironing clothes; services related to joint share in ownership; housecleaning services; health; other transportation (maintenance and repairs, school, air, intermunicipal, and international transportation); information and communications; recreation and culture; housing, bars, and discotheques; education (higher education, certificates, and non-formal educational courses); other miscellaneous services (personal care, insurance, childcare)
c/ Moderate EPS fees; certificates, administrative documents, and payment of fees.
Source: DANE, calculations by *Banco de la República* with provisional classifications

12 With respect to that, see: Caicedo, E. y Martinez, N. (2020), "Estimación del impacto de los alivios de precios sobre la inflación" (Estimated impact of price relief on inflation), Monetary Policy Report, July 2020, *Banco de la República*.

of last year. This led to significant price declines a year ago and major annual adjustments in goods and services between April and June 2021. In addition, a higher demand for private means of transportation (vehicles, motorcycles and bicycles) contributed to a higher annual adjustment in the CPI for goods. The CPI for services is being fueled by food away from home which, in turn, is affected by higher food costs, mainly animal protein. In contrast, rent, which represents close to a quarter of the household basket, has remained stable at levels close to 1.2% since January of this year and, thus, has helped to restrain upward pressure on services. In general, core inflation also incorporated higher national logistics costs due to blockages in ports and on the roads as well as those originated abroad by the increase in maritime freight rates, currently at historic highs, and the disruption of production chains. Added to this is the upward pressure from the increases in prices for imported raw materials and their transmission to domestic prices.

In the first half of the year, the CPI for food was the most affected basket by upward pressures from abroad and by the lower domestic supply of meat and the roadblocks in May. In the first quarter of 2021, the annual CPI for food trended downward largely due to a high base of comparison, but once the roadblocks occurred at the end of April, the trend changed and rebounded sharply in the second quarter (Table 2.3). Furthermore, higher production costs are being incorporated into the prices for processed foods due to factors that may tend to persist for several months such as increases in international commodity prices, problems with global supply chains, logistical obstacles, etc. This is compounded by the shortage of animal protein that is affecting the CPI for processed foods as a result of higher beef exports and a cycle in which cattle are being held back from slaughter. This situation resulted in beef production reaching a minimum level recently, with prices that are markedly higher. There has also been a shortage of chicken and eggs resulting from interruptions to the supply chain caused by the roadblocks during the national strikes.

The CPI for regulated items has risen from very low levels in response to climbing fuel prices and the reversal of utility rate reductions granted a year ago. The annual adjustment of the regulated items was at 0.73% in December last year thus reflecting the fall in international fuel prices and the reduction decreed at the end of the first quarter last year. Also, due to the relief on the payment of utilities established in several municipalities around the country at the beginning of the pandemic, and to lower prices for higher education due to reduced demand. This downward trend in the annual adjustment for regulated items changed in early 2021 when part of the higher international prices for crude oil were incorporated into the domestic fuel price (two increases of 200 pesos between February and March). This was accompanied by a significant increase in the CPI for utilities. The discounts granted on the fees for these were reversed and, in the case of energy and gas, the higher international fuel prices were incorporated. Likewise, the fees for utilities were driven by cost indexing[13] (energy and water) and higher investments, especially to improve coverage. This upward pressure along with a low baseline of comparison drove the regulated component of the CPI to end June with an annual growth of 5.93% (Table 2.3).

13 The indexation of public utilities costs refers to the fact that the fee formulas (energy and water) incorporate the largest increases seen in the CPI and PPI from some cost variables that are part of these formulas. In the case of municipal water supply, the rate for this service is updated when there is an accumulation of 3.0% consumer inflation. In the case of the price formula for energy, several of the cost components are tied to changes in the PPI such that a rise in the PPI automatically means an increase in these costs and in the final fee charged for this service.

For the remainder of 2021, the technical staff's estimates suggest that headline inflation will probably remain above 3.0% and resume its convergence towards the target in 2022. Core inflation is likely to remain on a growth trend towards 3.0% and, at the end of 2022, it could be around that value. Inflationary pressures from abroad, the adverse effects of the roadblocks on some of the agricultural production sectors, and the expected upward price trend for meat will probably contribute to a higher annual change in the CPI for food at the end of the year. The CPI for regulated items will probably slow down but register increases well above 3.0%. Core inflation (excluding food and regulated items), in turn, is likely to continue converging towards the target for the remainder of the year in line with the gradual closing of the output gap and elimination of the price easing implemented at the beginning of the pandemic. The latter would be associated with reversing the removal of indirect taxes on personal hygiene and cleaning goods that was planned for the third quarter of the year as long as the health emergency does not extend beyond 31 August 2021.[14] This is compounded by high international prices for supplies, commodities, and logistics costs in world trade which, together with pressure from the exchange rate, will probably affect the CPI mainly through the goods and food segments. The latter basket could also face limitations in the supply of several of its components, especially animal proteins, that will push the prices up for a few months. The low basis of statistical comparison on some components will also continue to have an impact on the annual change in prices for the remainder of the year. With all the above, the Bank's technical staff expects that the headline inflation will be around 4.1% at the close of 2021.

Agents' inflation expectations suggest temporary rises in inflation but they remain close to the target for the end of 2022. In recent months, the measurements of inflation expectations have tended to rise and suggest that headline inflation is likely to stand above 3.0% by year-end. However, at the close of 2022, the inflation expectations stand at values close to the target. To be specific, the measurement obtained in July from the Bank's *monthly survey of economic analysts' expectations*, shows an expected inflation of 3.7% at the end of 2021 and of 3.2% and 3.1% at twelve and twenty-four months respectively. The calculations derived from public debt securities (*break even inflation*, BEI) for July,[15] in turn, show inflation expectations of 2.7%, 3.1%, and 3.6% at two, three, and five years respectively.

This inflation forecast faces risks and high uncertainty. Future changes in prices in the Colombian economy are still surrounded by a higher than usual level of uncertainty. Although upward pressure from international prices and logistics costs in global trade is expected to continue, the estimate is that they will begin to gradually decline starting in the fourth quarter of the year. However, if these variables follow less favorable trajectories, they could put upward pressure on inflation to a greater degree for the remainder of 2021 and persist longer. Likely new waves of Covid-19 contagion, new roadblocks and unexpected increases in the exchange rate are also a major source of inflation uncertainty. The above risks are probably transitional in character and are likely to revert the year afterward and help lower inflation in 2022. Nevertheless, inflation that is higher than the target at the end of 2021 could have an impact on inflation expectations and on indexed prices in the economy.

14 The applicability of the VAT exemption on hygiene and cleaning goods is tied to the existence of the health emergency which, in principle, will probably end in August of this year. If it is extended for a longer period of time, VAT collection on these goods will continue to be deferred.

15 Based on information as of July 21.

2.3 Performance and Outlook for Balance of Payments

In the January-March 2021 period, the deficit in the current account in dollars and as a share of the GDP rose in comparison to the same period the previous year. In spite of the changing national and international economic and financial conditions caused by the Covid-19 pandemic, the first quarter of 2021 was characterized by the recovery of domestic demand. This was reflected in the expansion of the current deficit that was partially offset by the improvement in the prices of our main export goods. As a result, the country's current deficit climbed to an estimated 4.8% of the quarterly GDP between January and March 2021 in comparison to the 3.5% seen a year ago and 0.8 pp higher than what was registered in the fourth quarter of 2020. This is in an environment where the private sector's saving-investment balance continues to have a surplus. The rebound in economic activity caused a greater trade imbalance in goods and services where the increase in imports of goods for industry and agriculture and higher payments for transportation services accounted for much of the variation. Furthermore, there was a significant annual reduction in the surplus associated with tourism while higher outflows were seen due to profits for companies with foreign capital because of not only the recovery in economic growth but also the higher international commodity prices during the first quarter of 2021. There was an important growth, in turn, in exports of non-traditional goods, gold and coffee, and in workers' remittances, that reduced the foreign imbalance.

Foreign direct investment (FDI) was the main source of external financing in the first quarter of 2021. The rise in the current deficit during the first quarter of the year was in line with USD 3.162 billion (4.2% of the quarterly GDP) in net capital inflows, that were USD 996 m higher than what had been seen during the same period in 2020. Note that FDI once again became the main source of financing from abroad (USD 2.703 billion; 3.6% of the quarterly GDP) between January and March 2021. The above contrasts with what happened in 2020 when foreign public debt became the main source of funds for financing the external deficit. Despite the aforesaid, capital flows from FDI declined with respect to the first quarter of the previous year, mainly because of lower contributions received from capital inflows. Income from the net liquidation of USD 2.376 billion in Colombian capital abroad, mainly as a result of the reduction in financial assets (USD 3.542 billion from public sector entities) became another major source of financing for the current deficit between January and March 2021.

The technical staff forecasts that there would be an annual increase in the current account deficit for 2021 due to the expected reactivation of the Colombian economy and that it would be 4.5% of the GDP in comparison to the 3.4% seen in 2020. The expansion of the external imbalance would result from greater domestic absorption, in line with a larger fiscal deficit and a rebound in consumption and investment by the private sector. Together with an additional nominal boost from global expectations of high prices for supplies and products as well as high maritime freight rates for merchandise, this will likely lead to growth in dollar imports of goods and services. Moreover, the higher profits of companies with foreign capital participation would contribute to the expansion of the deficit due not only to the growth of domestic demand but also to the recovery of crude oil and coal prices. However, the forecast of the current account deficit anticipates trends that could limit its annual expansion. These include the recovery of terms of trade and of external demand, as well as income from workers' remittances that could remain at high levels. It is estimated that exports of goods could show significant growth in 2021 as a result of greater demand from our trading partners and upswings in the international prices for the main raw materials exported. Sales abroad of crude oil, industrial goods, gold, and the main agricultural products (coffee, flowers, and bananas) are expected to lead the rebound. However, it is worth mentioning that the restrictions on production and transportation that resulted from the roadblocks in the second quarter of 2021 have likely lowered the strength of export recovery. In addition, the volumes of coal and crude oil exported are not expected to reach pre-pandemic levels this year. The projected current account deficit is highly uncertain due to various factors such as changes in the pandemic and its economic impact, the many shocks affecting the price of petroleum, the effect of the decrease in fiscal stimulus in the United States on remittances, the increase in international interest rates, etc.

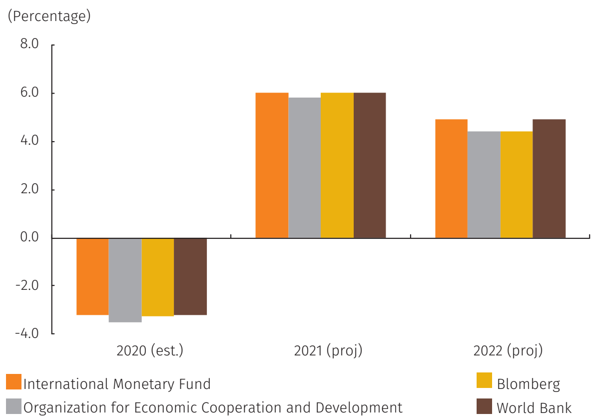
The technical staff anticipates that the country will continue to have access to various sources of foreign capital to finance all its current operations during 2021 but at a higher cost and with high uncertainty regarding financing conditions. The capital flows from FDI and to the public sector are expected to exceed the projected current account deficit for the year. This financing would contrast with the private sector's acquisitions of assets or reduction of liabilities abroad. In particular, expectations of high international prices for the country's exported commodities and the recovery of local economic activity will probably boost direct investments in Colombia during the year. The FDI levels would be lower in 2021 than those seen before the pandemic but could still account for a significant part of the current account deficit. The public sector's foreign financing, in turn, could be obtained through different mechanisms among which bond issuances, the acquisition of loans, and the partial liquidation of foreign assets would be the most important. Going forward, note that there are upside risks to the cost of foreign financing both in terms of the speed of monetary policy normalization in the United States and the future trend of the risk premia given Colombia's fiscal situation. Considering that the technical staff expects a larger current account deficit for 2021, the country would continue to accumulate foreign imbalances in an environment of rising risks on the cost of that financing.

2.4 Performance and Outlook for the International Macroeconomic Environment

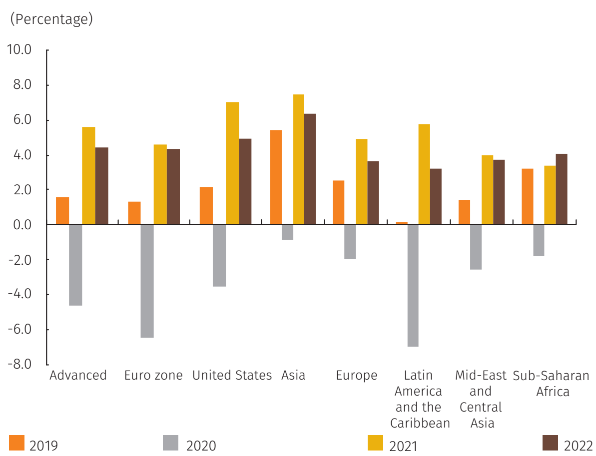
So far in 2021, worldwide economic growth has recovered from the sharp deterioration registered the previous year – a trend that could continue for the remainder of the year in the middle of high uncertainty about the development and impact of the pandemic. Various analysts and international organizations expect worldwide economic growth in 2021 to be between 5.8% and 6.0%. This represents a rebound from the previous year's drop, which was close to 3.3% (Graph 2.7, panel A). The expansionary monetary and fiscal policies of the major economies have been a significant factor in spurring that recovery. Likewise, the Covid-19 vaccination is likely to provide better control of the virus and progress on reopening several of the world's large economies. Furthermore, according to the Organization for Economic Cooperation and Development (OECD), the health measures to limit infection seem to be having less impact on economic activity partly because they are more targeted, and businesses and consumers have adapted better to the current environment. It should be mentioned that the differences seen in GDP growth rates between countries may persist due to disparities in the impact of the pandemic, the coverage of vaccination against the virus, and the economic support measures for the crisis, etc. (Graph 2.7, panel B). In particular, the positive trend and outlook for growth for China and the United States, the countries that are leading the global economic rebound in 2021, are noteworthy. Several Latin American countries, in turn, including some of Colombia's main trading partners, have been heavily affected by

Graph 2.7
Economic Growth
(annual change)

A. Global Economic Growth



B. Economic growth in different groups of countries[a/]



a/ Based on the forecasts made by the IMF in their July 2021 report.
Sources: Bloomberg, International Monetary Fund, World Bank, and OECD.

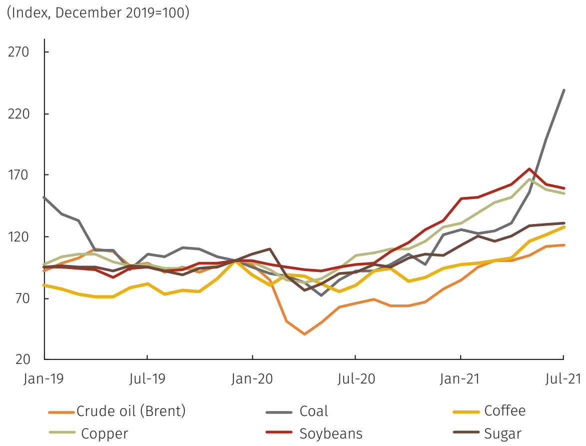
Covid-19 and this could limit their recovery. However, they are likely to benefit from a larger demand for their exports and better prices for raw materials. Thus, a 6.0% average GDP growth is expected of our trading partners after having registered a contraction of 6.7% in 2020. The uncertainty regarding economic activity abroad remains high since the development of the pandemic, particularly the implications of the emergence of new strains, is unknown. In addition, disruptions in global supply chains could continue to affect or limit the expansion of industrial production and put upward pressure on inflation on a global scale. There are risks, in turn, to the financial conditions abroad associated with the faster-than-expected normalization of monetary policy in the United States.

In the first half of 2021, the prices of several commodities exported by the country increased significantly, and this has contributed to the rebound in our terms of trade. The international prices for coffee, coal, and crude oil in the first half of 2021 were, on average, above those seen prior to the pandemic (Graph 2.8, panel A). Thus, the terms of trade improved 17% between January and April 2021 compared to the same period in 2020. In the case of crude oil, Colombia's main export product, its price in the first half of the year benefited from larger global demand for hydrocarbons associated with the recovery of worldwide growth and better prospects for it as well as a an increased mobility of the population. In addition, and in spite of the increased supply of crude oil, it remained restricted due to production cuts by the Organization of Petroleum Producing Countries (OPEC) and their allies as well as to the relatively slow recovery of oil production in other countries such as the United States. Along with this, the inventories of crude oil in OECD countries had declined as of May to levels close to those seen at the end of 2019 according to the Energy Information Administration (EIA). In the case of Colombia, the production of petroleum and coal had not reached the amounts seen prior to the pandemic during the first half of 2021.[16] The latter fact has limited the positive impact of the recovery of international prices for these products on exports and economic activity. Uncertainty about the changes in the price of crude oil remains high and will depend, in part, on OPEC+'s decision about their production levels, the negotiations with Iran on a nuclear agreement, and the response of other producing countries to higher prices. In terms of demand factors, the speed of reopening and recovery of the world economy, as well as the effectiveness with which the large crude oil consuming

16 The effects on coal production that persisted in the first half of the year are partially due to the fact that some mines have been closed since 2020. With the drop in international crude oil prices in 2020, in turn, the production in Colombia declined significantly and, in the first half of 2021, did not reach the levels seen before the appearance of Covid-19. According to the National Hydrocarbon Agency and Campetrol, activity in the sector did not reach the levels seen in 2019 either as shown by indicators such as the use of drills and number of exploratory wells. In addition to the above, there is the impact of the public order disturbances in May of this year on production.

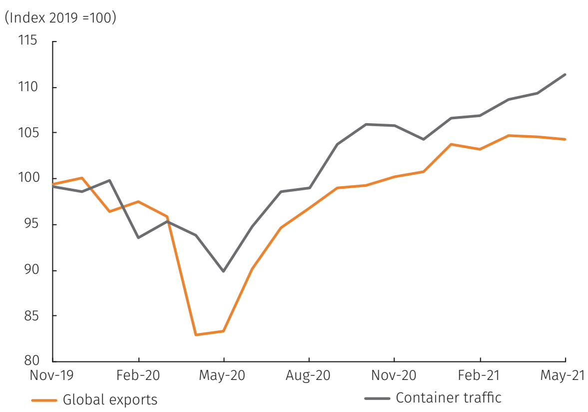
Graph 2.8

A. Prices of Some Commodities Exported by Countries in the Region



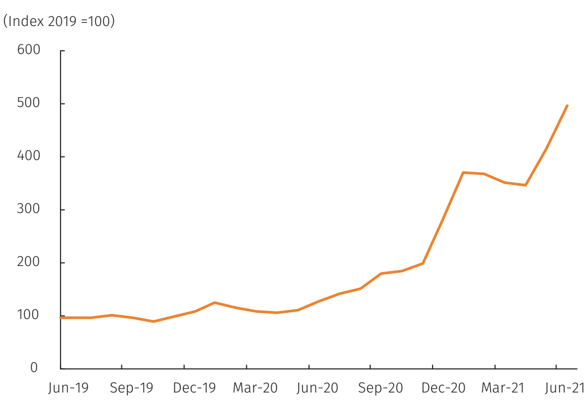
Note: the July data are the average as of the 27th of that month.
Sources: Bloomberg and Datastream, calculations by *Banco de la República*.

B. Real worldwide exports and container traffic[a/]



Sources: Institute of Shipping Economics and Logistics, CPB Netherlands Bureau for Economic Policy Analysis and Bloomberg.

Graph 2.9
International Container Maritime Shipping Costs



Source: Bloomberg.

countries control the pandemic are factors that could have an impact on this price.

The recovery of foreign trade has been accompanied by an increase in the prices of raw materials and in the costs of transportation logistics services and by the deterioration in supply chains. This will probably generate pressure on headline inflation, which, in principle, should be transitory. The recovery of the global economy and rise in the demand for goods (Graph, panel B) have occurred in the middle of bottlenecks and disruptions in global supply chains in various markets, and this has pushed international prices for supplies and products up. An example of this has been the shortage of semiconductors and its impact on the automotive industry. In the case of raw materials, there has been widespread growth in their prices including those for crude oil, minerals, and food (Graph 2.8, panel A). For the latter group of goods, the higher prices of corn, palm oil and soybean and its derivatives stand out. These products have been characterized by a strong demand, even from China, and a limited supply that, in some cases, is the result of climate factors and the impact of the pandemic. In addition to the above, there has been an increase in freight transportation costs which, according to the OECD, is partly related to the increase in demand for durable goods produced in Asia and to the impact of the sanitary restrictions resulting from the pandemic on the operation of ports and terminals.

Rises in inflation and inflation expectations have been observed in several economies. In the United States total annual inflation in June was 5.4% and core inflation was 4.5%. These results were higher than what the market had expected. The low annual basis of comparison, the rise in the international crude oil prices, disruptions in the global supply chains, the reopening of several sectors, and higher labor costs contributed to this high headline inflation and all of it in an environment of recovering demand. Going forward, inflation expectations have risen and are above 4.0% for the end of 2021. The U.S. Federal Reserve has indicated that some of the factors putting upward pressure on inflation are likely to be temporary and the outlook of analysts show that headline inflation will probably stand somewhat above 2.0% at the end of 2022. On the regional level, annual inflation and inflation expectations for the last quarter of 2021 that are higher than the respective long-term targets have been seen in several countries. For example, inflation in Brazil and Mexico was 8.35% and 5.88% respectively in June. These results with respect to inflation and their upside risks have caused the central banks of these countries to raise their monetary policy rates in recent months.

From the beginning of the year to June, the flow of workers' remittances has continued to contribute to national income. USD 3,987 billion in remittance inflows were registered between January and June 2021. This represented a 29% and

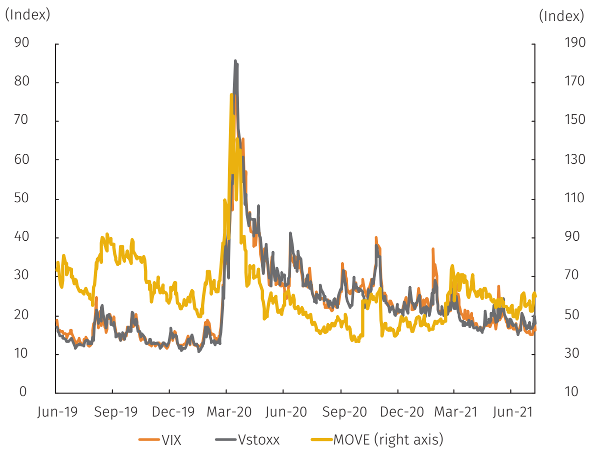
24% increase compared to the same periods in 2020 and 2019 respectively. In the first quarter of the year, the allocation of these funds was concentrated in the departments of Valle del Cauca, Antioquia, and Cundinamarca. For the same period, workers' remittances and growth in remittances came mainly from the United States followed by Spain, countries that have historically been a major source of this income and where a large percentage of Colombians living abroad are located. In these countries, government support and improvements in the labor market are likely to favor household income. In addition, one of the motivations for migrants to send remittances to their country of origin is to support the well-being of their families, and high unemployment rates and increasing poverty in Colombia could be driving the inflows of these resources. It should be noted that the increase in workers' remittances is not unique to Colombia, and this phenomenon is also seen in other economies in the region. Going forward, trends in migration, economic conditions at home and in the countries where migrants reside as well as the scaling back of the fiscal stimulus in the United States could be determining factors in workers' remittances.

Colombia kept access to various sources of foreign financing in the first half of 2021 in an environment of ample international liquidity despite the increase in Colombia's risk premium and the higher long-term rates in several advanced economies. In the first half of the year, the U.S. Federal Reserve and the European Central Bank maintained their expansionary monetary policy and announced that they would maintain this stance until they reached their long-term objectives. This has favored international liquidity conditions. However, at the end of the six-month period, the interest rates on US Treasury bonds, including long-term ones, were above the levels seen at the beginning of the year in a scenario of strong fiscal stimulus and higher expectations of economic growth, inflation, and employment. Going forward there is uncertainty in the markets about changes in the variables that could affect the speed at which monetary policy is normalized in the United States, in both its balance sheet and its policy interest rate, a process which, if it occurs quickly or unexpectedly, could generate less favorable external financial conditions for emerging countries. In this environment, which also included higher petroleum prices, Colombia experienced increases in interest rates on public debt securities, rises in its risk premium, and a depreciation of the currency during the first half of 2021, compared with what was registered at the end of 2020 (Graph 2.10, panels B and C, and further ahead Graph 2.13, pg. 36). The five-year *credit default swaps* (CDS), the peso-dollar exchange rate, and the zero coupon, peso-denominated, ten-year TES rate, in particular, were, on average, 135 bps, COP 3,693 per dollar, and 753 bps respectively in June. These figures are higher than those registered in December 2020 and in the year prior to the pandemic.[17] Related to these results, and as detailed in section 2.5, S&P Global Ratings downgraded the credit rating for Colombia's long-term foreign currency public debt on May 19 from BBB- to BB+ with a stable outlook, and Fitch Rating also downgraded the rating for the country's long-term foreign and local currency debt from BBB- to BB+ on July 1. Both rating agencies highlighted the country's fiscal situation as a determining factor for this decision. In terms of capital flows, the balance of payments reported an improvement in foreign direct investment in the first quarter of the year, compared to the end of 2020. Exchange balance figures also show a quarterly recovery of portfolio investment in the second quarter of 2021. This indicates that the country maintains access to different sources of foreign financing, albeit at a higher cost.

17 The five-year CDS, the peso-dollar exchange rate, and the zero coupon, peso-denominated, ten-year TES rate were, on average, 90 bps, COP 3,468, and 588 bps in December 2020. The five-year CDS, the peso-dollar exchange rate, and the zero coupon, peso-denominated, ten-year TES rate were, on average, 99 bps, COP 3,282, and 650 bps in 2019.

Graph 2.10
Index of Volatility in International Financial Markets, Nominal Exchange Rate and Risk Premium (five-year CDS) for Some Economies in the Region

A. Financial Volatility Indices



B. 5-year Credit Default Swap (CDS)

C. Nominal Exchange Rate

Source: Data License.

2.5 Performance and Outlook for Financial and Credit Markets

2.5.1 Financial Markets

So far in 2021, with the exception of stock markets, most international financial markets deteriorated as a result of the uncertainty regarding the Federal Reserve's (Fed) interest rate movements and the progress of vaccinations around the world. During the first quarter, financial markets were adversely affected by the increase in the perception of international risk due to the increase in new cases of Covid-19, the appearance of new strains, uncertainty regarding the vaccination process (especially in emerging countries) and the increase in U.S. Treasury bond rates. The latter has been associated with expectations of an earlier-than-expected increase by the Fed in the range of the federal funds rate in response to better economic data and the inflationary pressure associated with rapid economic recovery as well as the higher fiscal spending which, in turn, increased the budget deficit (Graph 2.10, panel A). Starting in the second quarter, the increases in US Treasury rates eased to the extent that the market assumed that inflationary pressure could be transitory. Thus, the international financial markets were mostly influenced by local factors during that quarter, especially the financial markets in the region.[18] Global stock markets, in turn, were not as sensitive to the changes in international monetary policy expectations and have been by the favorable economic growth. In this context, the year has seen an increase in risk premia for emerging economies. In the case of Latin America, even though the prices of some commodities that are important to the region, for example crude oil and copper, have risen, risk premia have been affected by some local factors, especially the political, fiscal, and health uncertainty (associated with the lower rate of vaccination). Thus, as of 9 July 2021, the 5-year CDS had risen 49 bp in Colombia, 30 bp in Brazil, 25 bp in Peru, 13 bp in Chile, and 11 bp in Mexico (Graph 2.10, panel B).

In Colombia, most financial markets have deteriorated over the course of the year to a greater extent than those of emerging countries and the region. Colombian financial markets have been affected by some restrictions on movement, concerns about the vaccination process and the domestic fiscal situation, the uncertainty associated with discussions about the fiscal reform in Congress and its subsequent withdrawal, the demonstrations and roadblocks at various points around the country, and to a large extent, by the expectations that the country's credit rating would be downgraded to below investment grade.

18 In this region for example, financial markets in Chile and Peru have been affected by political uncertainty following local and constitutional convention elections in Chile and the presidential elections in Peru. In Brazil, meanwhile, markets have been influenced to a greater extent by uncertainty on the fiscal front.

S&P Global Ratings (S&P) lowered the country's sovereign debt rating to below investment grade with a stable outlook on 19 May 2021 while citing a fiscal adjustment that could be prolonged along with other concerns. Subsequently, Fitch Ratings made the same decision on July 1, citing reasons similar to those of S&P.

In line with the decline in asset prices, there has been a reduction in their liquidity indicators although they are at better levels than those seen at the beginning of the Covid-19 crisis (March 2020). There was an improvement in TES liquidity, in particular, at the beginning of the year and up through mid-February, at which time U.S. Treasury rates began to rise significantly thus affecting the TES performance negatively. Afterwards, there was a reduction in the liquidity of these securities, and this led to the average bid-ask spread (BAS)[19] for the year to date being lower than the average seen in the second half of 2020.[20] Liquidity in the foreign exchange market[21] has also deteriorated over the course of the year. To be precise, following the announcement by the rating agencies that they had downgraded Colombia's sovereign debt, there were episodes of further deterioration in the liquidity of this market.[22]

The Colombian peso has depreciated as a result of higher risk perception and the trends of some local factors. So far this year,[23] the US dollar has experienced a 2.7% increase against the main advanced economies[24] and one of 3.7% against the main Latin American currencies.[25] In this region, the Colombian peso (11.6%), the Peruvian sol (9.6%), the Chilean peso (5.1%), and the Brazilian real (1.3%) have depreciated vis-a-vis the U.S. dollar while the Mexican peso has appreciated (0.2%) (Graph 2.10, panel C). The Colombian peso's depreciation with respect to the dollar initially reflected a less favorable international context for risky assets and, subsequently, it was influenced by the abovementioned local factors. However, the increase in crude oil prices,[26] the sales of dollars by the General Office of Public Credit and the National Treasury (DGCPTN in Spanish), and the dollar inflows from foreign investors during the second quarter may have restrained the upward pressure on the exchange rate (Graph 2.11).

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19 The BAS is calculated as the average (daily) of the difference between the best purchase point and best selling point for each second between 9:00 AM and 12:30 PM each day for securities. Securities with no bids are assigned the maximum BAS of the day for securities that had bids. Therefore, an increase in the indicator reflects lower liquidity.

20 During January and the first half of February, the average BAS for peso-denominated TES stood at 1.9 bp which is below the 4.1 bp average seen during the second half of 2020. From mid-February to May 19 (S&P rating cut-off), the average BAS went to 4.8 bp and, subsequently, marginal rises of 0.2 bp were seen.

21 For the exchange market, the BAS is calculated as the average of the difference between the best purchase point and best selling point in the setfx spot session for each second between 8:30 AM and 1:00 PM each day.

22 The average BAS was COP 1.87 in the first half of 2021 compared to COP 1.70 in the second half of 2020.

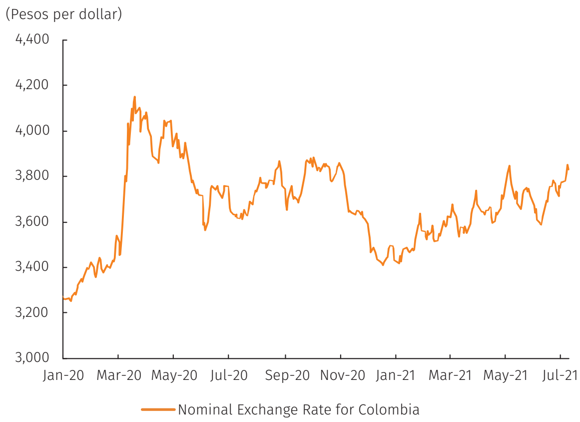
23 Information as of 09 July 2021.

24 In accordance with the DXY, which includes the euro, the Japanese yen, the Canadian dollar, pound sterling, the Swedish krona and the Swiss franc. This group of currencies corresponds to those of the United States' main trading partners.

25 This is based on the Latam Currency Index (LACI), an index that tracks the performance of the main Latin American currencies against the dollar: the Brazilian real (33%), the Mexican peso (33%), the Chilean peso (12%), the Argentine peso (10%), the Colombian peso (7%), and the Peruvian sol (5%).

26 Over the course of 2021, the Brent crude oil price has risen 46% and the WTI, 54%.

Graph 2.11
Nominal Exchange Rate

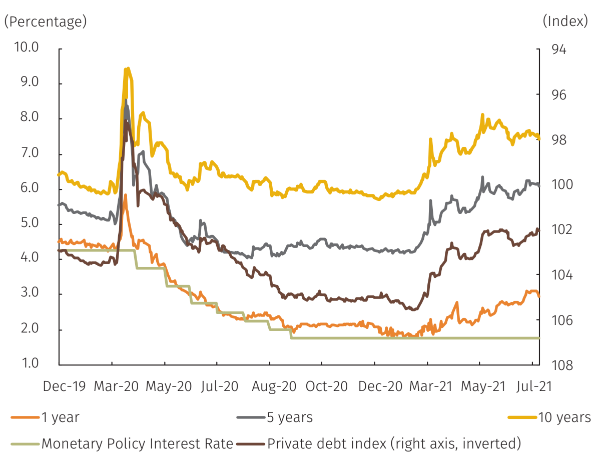


Source: Data License. Data as of 09 July 2021

Graph 2.12
Interest Rate Indices in Some Latin American Economies

Sources: Bloomberg, SEN (electronic trading system) and Master Trader, calculations by *Banco de la República*.

Graph 2.13
Zero-coupon TES Rate in Pesos by Maturity, Private Debt Index, and Monetary Policy Rate



Sources: SEN (electronic trading system) and Master Trader, calculations by *Banco de la República*.

Over the course of 2021, deteriorations have been seen in local and foreign public debt and foreign inflows to the local public debt market. The interest rates for public and private debt securities rose during the first quarter as was the case with the other countries in the region following the increase in interest rates in the United States (Graph 2.12). The rates continued to rise in the second quarter because of local uncertainty and expectations that *Banco de la República's* monetary policy trajectory would be less expansionary[27] (Graph 2.13). In this context of rising interest rates (over the course of the year the ten-year TES rate rose 167 bp), foreign investors' net demand for TES has come to COP 10.6 b[28] during the year, especially since April. According to several market analysts, the foreign investors' marked demand is due to expectations that the prices of these securities would be corrected considering the fact that they have already largely incorporated the local uncertainty and a possible loss of investment grade rating. With respect to this, long-term rates were partially lowered following the decision by S&P and Fitch.

The Colcap index fell 10.1% during the year.[29] The Colcap index has lagged significantly behind other stock indexes in the region (+2.6%) over the course of the year. This has been explained by the aforementioned local factors. Furthermore, it has been under pressure from the poor performance of financial sector stocks and the ongoing outflows at the hands of foreign investors who have sold a net COP 1.248 billion (up to June).

Throughout the year, markets had been incorporating the expectation of a possible reduction in the credit rating of Colombian debt into asset prices. As a result, after S&P and Fitch's decision, there was no significant subsequent impact on the local debt market and the exchange rate. S&P decided to downgrade Colombia's sovereign debt in foreign currency to below investment grade rating on May 19. According to the rating agency, this decision was made based on the expectation that the fiscal adjustment would be more prolonged and gradual than previously expected, and this reduces the likelihood that the deterioration of public finances will be curbed in the short term. Nevertheless, the new rating has a stable outlook because the rating agency expects the economic recovery, together with fiscal adjustments, to stabilize the country's debt burden within the next two to three years. The day after the surprise announcement (in April 2021, the rating agency

27 According to *Banco de la Republica*'s monthly survey of economic expectations, in January, analysts on average expected a first policy rate hike in December 2021 while, in June, they indicated that they expected a first increase in October. At twenty-four months, the expected rate went from 3.25% in January to 3.5% in June.

28 These investors have demanded COP 9.0 b in TES on the spot market and COP 1.6 b in the futures market as of July 9.

29 Information as of 09 July 2021.

had confirmed the sovereign rating at investment grade) by S&P, Colombian financial assets showed a marginal deterioration that then later corrected itself during the following days.[30] This made it evident that asset prices had already incorporated the possible loss of investment grade into their prices during the previous months. Subsequently, Fitch Ratings echoed S&P's decision on July 1. This rating agency stated that the downgrade reflects the deterioration of public finances with large fiscal deficits for the 2020-2022 period, a rising level of public debt, and less confidence in the government's ability to credibly steer the debt onto a downward trajectory in the coming years.

For the second half of 2021, the performance of local financial markets as well as possible changes in credit ratings by other agencies will depend on the fiscal adjustment program approved by Congress, the number of people vaccinated, the speed at which employment and the economy recover, and the international context. The performance of financial markets will depend, to a large extent, on the fiscal reform approved by Congress in the second half of the year. The market expects the reform to raise additional funds in excess of 1.0% of GDP in the medium term in order to stabilize and eventually lower the trajectory of public debt. Market performance will also depend on the speed of vaccination (on July 7, the country surpassed 20 million doses applied),[31] the pace at which employment and the economy recover (the national unemployment rate stood at 15.6% in May which was below the 21.4% seen in May 2020, but still above the 10.5% seen in May 2019) as well as the international context (interest rates in the United States, growth of our trading partners, prices for raw materials, etc.)

2.5.2 Credit Institutions' Financial Intermediation

As a percentage of GDP, the aggregate stock of loans is at levels higher than those seen in the pre-pandemic period. Nevertheless, the increase in disbursements has been lower than the growth of output over the course of 2021. This performance of credit has been determined by both supply and demand factors. As of March 2021, the aggregate stock of loans as a percentage of GDP was above the levels seen before the pandemic and its medium-term trend (Graph 2.14, panel A). Nevertheless, the performance of the quarterly disbursements of the total portfolio has weakened in recent months since they fell sharply after the pandemic shock in March 2020, and their growth rate in the following months was much lower than that of output. Although the quarterly ratio of disbursements to GDP has shown a recovery in recent months, it has not reached the levels observed pre-crisis (Graph 2.14, panel B). This recent performance of credit has been determined by both supply and demand factors. According to *Banco de la República*'s Survey of Credit Markets Situation in Colombia, the perception of credit institutions (CIs) regarding credit demand fell sharply after September 2019 and did not move into positive territory until the first quarter of 2021.[32] Given the increase in the perception and materialization of risk in the economy derived from the health crisis, CIs, in turn, raised their requirements for granting loans throughout 2020 and only

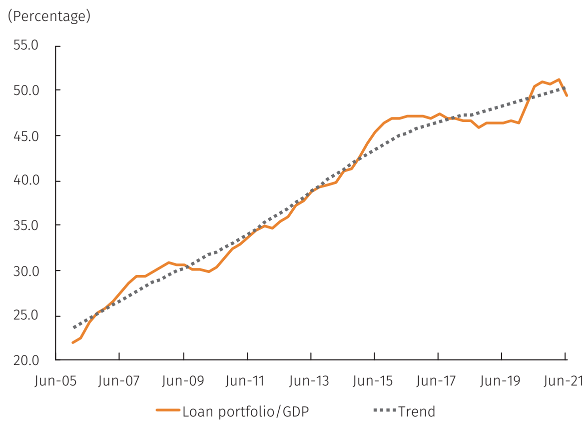
30 The day after the decision was announced, the Colombian peso depreciated 1.06%, the Colcap index declined 0.87%, the five-year CDS rose 2 bps, and peso-denominated TES depreciated 6 bps on average.

31 Based on the figures from the Ministry of Health.

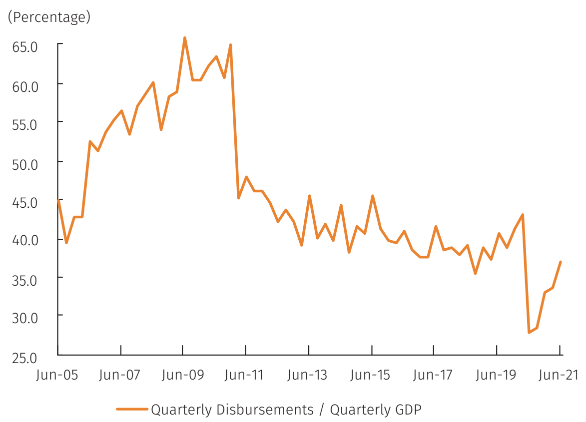
32 *Banco de la Republica*'s *monthly survey of economic expectations* also points to a recovery in the perception of credit availability although it is below the levels registered in 2019.

Graph 2.14
Portfolio and Disbursements Relative to GDP

A. Loan Portfolio/GDP

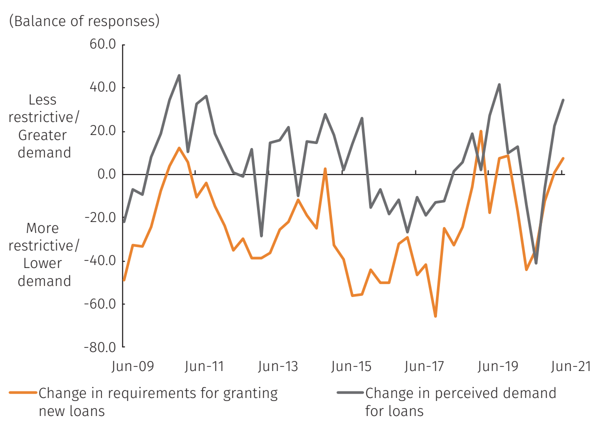


B. Quarterly Disbursements / Quarterly GDP



Note: the trend is calculated using the Hodrick-Prescott filter with a lambda parameter of 1600. June 2021 GDP data are projections based on the April 2021 Monetary Policy Report.
Sources: Office of the Financial Superintendent of Colombia (credit establishment balances and form 088) and DANE, calculations by *Banco de la República*.

Graph 2.15
Perception of Supply and Demand Indicators for Credit Institutions



Source: *Banco de la República* (*Survey of the loan situation in Colombia*).

in the most recent survey did the indicator register levels close to zero[33] (Graph 2.15).

The performance of credit has been mixed among the different loan categories. Over the course of 2021, mortgage disbursements stood out with higher growth than that of output and at record heights. The increase in the banks' requirements for granting new loans and the lower demand from companies and households has led to lower growth in total credit (Graph 2.16, panel A) although the performance is mixed. Mortgage loans, which represens nearly 15% of the total, was the only category that has continued to increase steadily since March 2020. Mortgage disbursements reached record highs[34] with significant growth compared to 2020, and even compared to 2019, particularly in the non-LIH segment.[35] This is in line with the housing market's dynamism during 2021 in a context of programs to boost the purchase of new housing by the government. For commercial and consumer loans, volume growth so far in 2021 has been low and has been affected by the changes in the level that these categories underwent during the second quarter of 2020.[36] The disbursements for these categories, in turn, were slightly lower than in 2019. Compared to 2020, commercial loans disbursements so far in 2021 have been similar in amount although there have been changes in make-up that favor preferential and treasury portfolios. For consumer (including credit cards) and microloans , the recovery in disbursements compared to 2020 has been significant although they remain at levels lower than those seen in 2019[37] (Graph 2.16, panel B).

33 The perception indicators in Graph 2.15 correspond to a balance between responses indicating increases or decreases in the perceptions of credit supply or demand with respect to the previous quarter. Given this, an indicator in negative territory indicates that a majority of credit institutions perceive that the supply or demand for loans is decreasing.

34 Information has been available since May 2002.

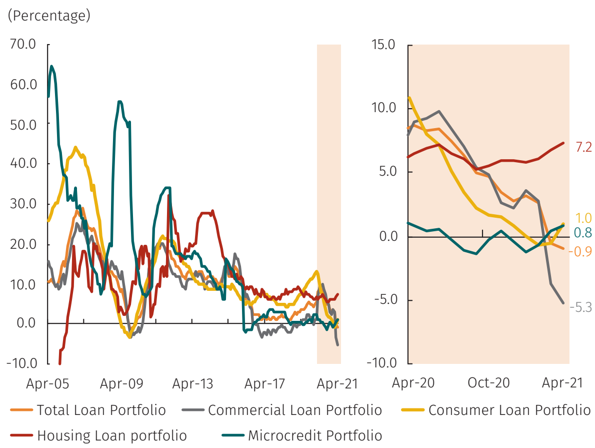
35 Quarterly disbursements for non-LIH housing purchases had grown 162.5% as of May 2021 and for LIH housing, they had grown 101.1% in annual terms.

36 In the first half of 2020, the average annual growth of commercial loans was 2.0% (4.6% in the first quarter and -0.6% in the second quarter) and that of consumer loans was 2.2% (1.0% in the first quarter and 3.4% in the second). In the case of commercial loans, disbursements increased substantially (and with them the stock of loans) at the beginning of the pandemic due to the uncertainty that companies faced regarding their cash flows. Subsequently, once the actual cash needs became evident in the second half of 2020, the demand for commercial loans decreased and several of these loans were repaid. This resulted in a drop in the stock of this type of portfolio. In the case of consumer loans, unlike the commercial category, its stock fell in the second quarter of 2020, and then began to recover.

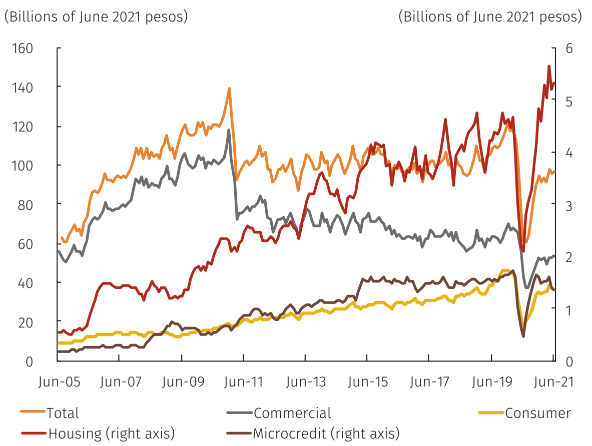
37 The average commercial disbursements so far in 2021 have been 4.4% lower and consumer disbursements have been 2.0% lower with a significant reduction in disbursements other than loans covered by automatic payroll deductions compared to 2019. Compared to 2020, disbursements in commercial loans rose 2.8% with a significant increase in preferential and treasury disbursements, and a reduction in ordinary disbursements. In consumer loans, the increase in disbursements has been more significant, 33.8%, with a similar pattern in both loans covered by automatic payroll deductions and others.

Graph 2.16
Portfolio Trends by Category

A. Real Annual Growth of the Loan Portfolio

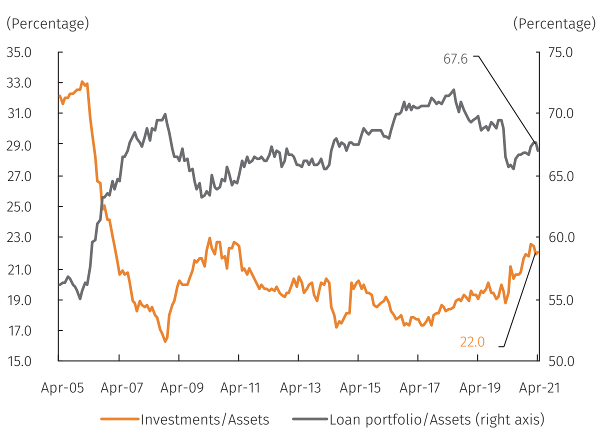


B. Quarterly Disbursements / Quarterly GDP



Sources: Office of the Financial Superintendent of Colombia (credit establishment balances and form 088) and DANE, calculations by *Banco de la República*.

Graph 2.17
Breakdown of Credit Institutions' Assets



Source: Office of the Financial Superintendent of Colombia (credit establishment balances), calculations by *Banco de la República*.

The performance of total credit has been accompanied by a slight recomposition of CI assets with a greater contribution of public debt securities. The weaker loan growth has coincided with a progressive increase in investments in the CI asset portfolio which reached a 22.0% share at the close of the first quarter of 2021, a figure that has not been seen since mid-2011 (Graph 2.17). In mid-2020, the CIs made temporary mandatory investments in Solidarity Securities for an amount that was close to COP 10 b.[38] This meant a significant growth in the investment volume (close to 9.0% at the time the mandatory investment was made). In recent months, the investments as a share of the total assets have tended to stabilize.

So far this year, the reductions in the policy rate made in 2020 have continued to be transmitted to lending rates. As of June 2021, and despite some increases during that month, the interest rates of most credit categories showed a downward trend (except for the credit card and microloan categories) and reached historic lows during the six-month period (Graph 2.18). Specifically, the interest rates of commercial, consumer, non-LIH mortgages, and LIH mortgages fell 229 bp,[39] 193 bp,[40] 156 bp, and 121 bp[41] respectively compared to March 2020. The credit card interest rate for individuals, in turn, fell 84 bps compared to March 2020, and the microloans rate rose 127 bps. Based on previous studies, policy rate movements are historically transmitted fastest to commercial rates, followed by consumer rates and, lastly, credit card, mortgage and microloan rates. In the last three categories, transmission is weakened due to the presence of various factors.[42] In the case of microloans, the high costs of client selection and monitoring, the worse credit profile, and the sensitivity of the sector to the dynamics of the economy make the transmission of rates difficult.

CIs liabilities have declined since September 2020, mainly due to a decrease in term deposits. There is still a greater preference for demand deposits, where interest rates have declined significantly, but less than those of term deposits.

38 Decree 562/April 2020.

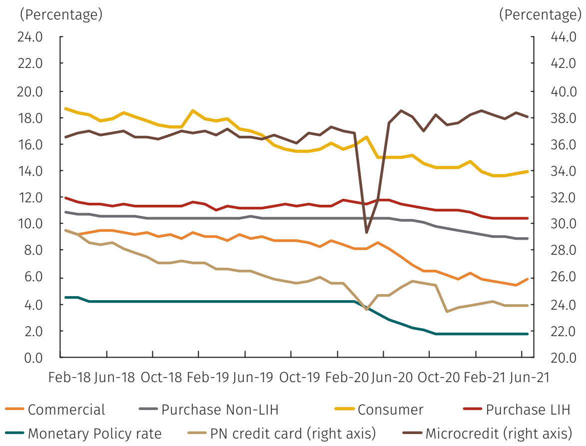
39 Going by sub-category, the commercial rates decreased 243 bp for prime, 225 bps for ordinary, and 116 bps for treasury loans in comparison to March 2020.

40 Compared to March 2020, the rate for consumer loans covered by automatic payroll deductions dropped 199 bp and those other than loans covered by automatic payroll deductions dropped -137 bp.

41 Part of this decrease is the effect of the reduction in inflation through rates expressed in UVR. This has been accompanied by a change in the components of loans in favor of those denominated in pesos and has reduced the share of those denominated in UVR.

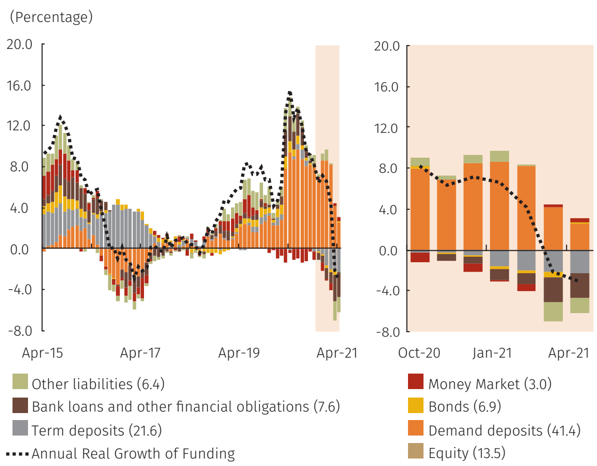
42 For example, the credit risk of those agents that demand microloans and the size of the CIs that offer this type of credit. See Box 1: "The Transmission of Changes in the Monetary Policy Interest Rate (MPR) to the Credit Institutions' (CE) Interest Rates in the March 2021 *Board of Directors' Report to the Congress of the Republic*, page 99.

Graph 2.18
Policy Rate and Lending Rates



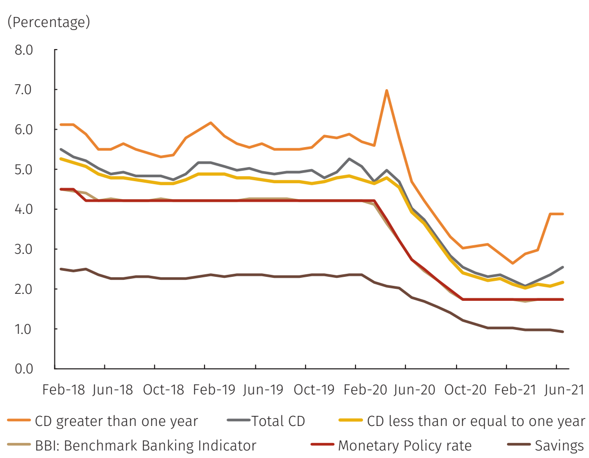
Note: amount-weighted average monthly rates.
Source: Office of the Financial Superintendent of Colombia (form 088), calculations by *Banco de la República*.

Graph 2.19
Annual Real Growth of Funding



Note: the share each item has in the funding is in parenthesis (liability + equity).
Source: Office of the Financial Superintendent of Colombia (credit establishment balances), calculations by *Banco de la República*.

Graph 2.20
Policy Interest Rate, BBI, and Deposit Interest Rates



Source: Office of the Financial Superintendent of Colombia (form 441), calculations by *Banco de la República*.

After the expansion observed following the measures adopted by *Banco de la República* to inject liquidity into the economy and depositors' greater preference for liquidity due to greater uncertainty and risk aversion, the entities' funding has gone through a downturn. This is explained by the decrease in term deposits, particularly those with maturities of more than one year (the volume of which fell sharply),[43] bank credit and other financial obligations, and bonds (Graph 2.19). Long-term deposits (maturity greater than one year) have decreased by an average of 16% per annum so far in 2021. In contrast, demand deposits continued to increase significantly (16.5% on average for the year to date and 11.3% in the second quarter). This trend suggests that the preference for liquid deposits persists, in spite of the low levels and reductions in interest rates since March 2020. As of June 2021, the savings account rate was at historical lows (0.96%), 123 bps lower than the rate in March 2020.[44] Although the aggregate CD rate is higher than the savings rate (2.52% on average in June), it fell more sharply and reached historical lows in February and March 2021 for most maturities (Graph 2.20). Since then, there have been increases in some maturities, particularly those equal to or greater than one year. As of June, the aggregate CD rate stood 220 bp below the one in March 2020 and 20 bp above the one in December 2020 as a result of the recent increase in rates and amounts borrowed at long maturities.

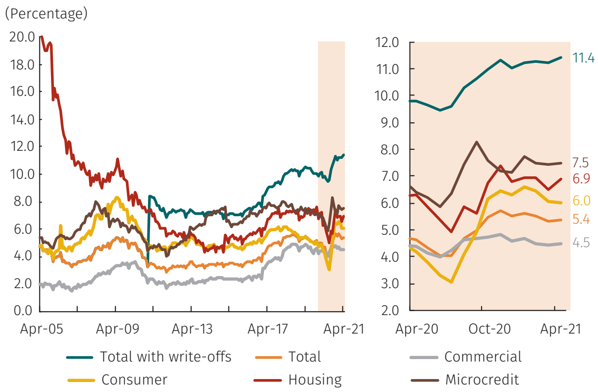
After increasing since the second half of 2020, credit risk indicators, including write-offs, have been showing a stable performance starting February 2021. This stabilization was accompanied by the extension of the Debtor Assistance Program (*Programa de Acompañamiento a Deudores*, PAD) to 31 August 2021. In a context of economic contraction and rising unemployment during 2020, debtors' ability to pay was strongly affected, and as a result, the non-performing loans ratio (NPLR) showed generalized increases for all categories of loans. The increases have been more pronounced in the case of consumer loans and mortgages. This was expected considering that those who had household loans were the ones that mostly took advantage of the grace periods authorized by the Office of the Financial Superintendent of Colombia (FSC) (external circulars 007 and 014/2020), which began to expire during the second half of 2020. So far in 2021, the indicators NPLRs with and without write-offs have stabilized and, in November 2020, registered the highest level seen since the end of 2004 (Graph 2.21, panel A). Although the future performance of these indicators is still uncertain once the SFC's PAD expires, the entities have

43 The stock stands at levels similar to those seen at the end of 2016.

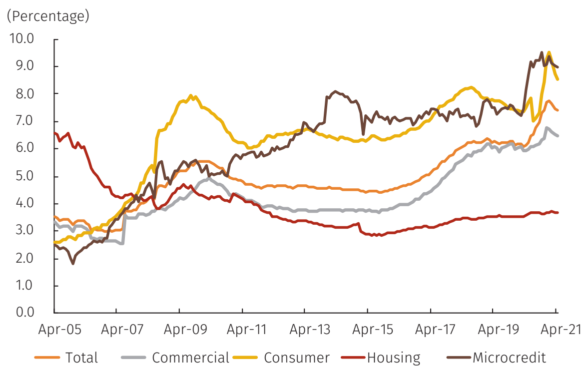
44 Despite the fact that the reduction in the savings rate is less than the decrease in the CD rates, it is considerable relative to the level registered in March 2020 (the rate registered in June 2021 is equivalent to 45% of the average rate in March 2020). The decreases in savings account rates occurred mainly in accounts of legal entities and official entities and, to a lesser extent, in the accounts belonging to individuals (their level is lower).

Graph 2.21
Portfolio Quality and Coverage

A. Quality Indicator by Default



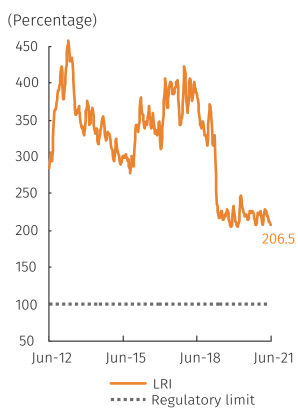
B. Loan-loss provisions/Loan Portfolio



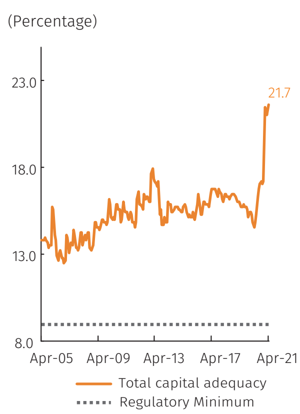
Source: Office of the Financial Superintendent of Colombia (credit establishment balances), calculations by *Banco de la República*.

Graph 2.22
Credit Institutions' Capital Adequacy and Liquidity Indicators

A. LRI



B. Capital Adequacy



Note: the LRI refers to the liquidity risk indicator that measures the ratio of liquid assets to net liquidity requirements over a 30-day horizon for all credit institutions. With External Circular 009/2018 of the Financial Superintendency of Colombia going into effect as of March 2019, the 30-day net liquidity requirements of the LRI are calculated based on the type of depositor. Therefore, the aggregate measure shows a decrease due to this regulatory change.
Source: Office of the Financial Superintendent of Colombia (credit establishment balances and form 458), calculations by *Banco de la República*.

increased the level of loan-loss provisions they have to face the possible materialization of credit risk (Graph 2.21, panel B).

Over the course of 2021, CIs have preserved their capital adequacy and liquidity levels, which are well above the regulatory minimums. Aggregate liquid assets continue to significantly exceed the value of the net 30-day liquidity requirements, and as of 28 May 2021, the entities registered a Liquidity Risk Indicator (LRI) of 215.1% (Graph 2.22, panel A). Furthermore, the financial system raised its capital adequacy levels starting in the second half of 2020 and even more so during the first few months of 2021 (Graph 2.22, panel B) due, mainly, to three factors: 1) the full implementation of Basel III in early 2021 under the guidelines of decrees 1477/2018 and 1421/2019; 2) lower asset growth, and 3) the restructuring of loan portfolio assets into investments.

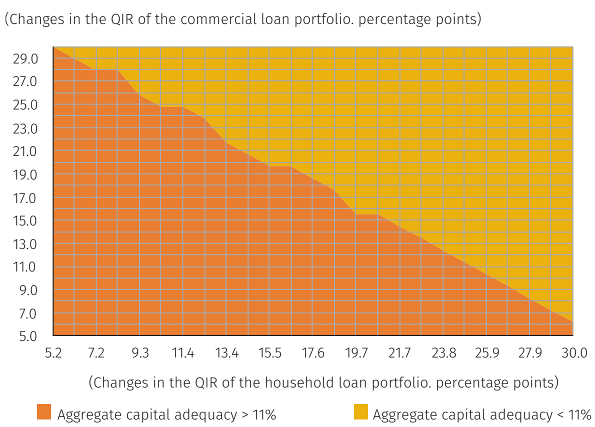
The aggregate profitability of CIs continued the downward trend that has been seen since August 2019. This was largely due to the increase in outlays on loan-loss provisions made by the entities in anticipation of the higher credit risk and to the decline in income from the loan portfolio. In the middle of the current situation caused by Covid-19, the return on CI assets (ROA) continued the downward trend it had been showing since August 2019 which meant that some of the CIs began to show losses (Graph 2.23). In February 2021, the indicator registered a low of 0.7%, with a modest recovery in March. Between March 2020 and the same month in 2021, the ROA indicator declined as a result of profits that fell at a rate of 52.8% in real annual terms and closed at 0.8%, a value that has not been seen since June 2002. The lower earnings reflected the lower income from the commercial and consumer loan portfolios and the drop in commissions and fees, but mainly the higher spending on loan-loss provisions derived from the appearance and materializing of credit risk as well as the expectations of more deterioration. If the trend of credit risk materialization continues, profitability will probably remain at low levels.

Stress tests suggest that the aggregate financial system has the resilience to face even more adverse credit risk scenarios. This goes hand in hand with the increase in loan-loss provisions made by CIs, in anticipation of greater deterioration of the portfolio at the cost of substantially lower profitability. In *Banco de la República*'s Financial Stability Report for the first half of 2021, there was a reverse stress test that sought to assess the financial system's resilience to different levels of portfolio loan and changes in the quality indicator by risk (QIR, the ratio of risky loans to total loans, Graph 2.24). This analysis consisted of quantifying the impact on the capital adequacy of the CIs in the event of extreme, hypothetical, and adverse scenarios and does not constitute any forecast of changes in macroeconomic conditions nor the probable development of the financial system. The exercise suggested that the QIR would have to be at levels above 29% towards the end

Graph 2.23
ROA

Source: Office of the Financial Superintendent of Colombia (credit establishment balances), calculations by *Banco de la República*.

Graph 2.24
Total Capital Adequacy for Different Shocks from QIR by Type



Note: each point on the graph represents a simulated combination of the change in the QIR of the commercial loan portfolio and the QIR of household loan portfolio at the end of 2022. The colors for each of these points represent the aggregate capital adequacy of the system if these shocks were to materialize. Those that are orange represent sufficient capital adequacy and the yellow represents a situation of vulnerability where the aggregate capital adequacy of the system falls below a prudent level of 11%.
Source: Office of the Financial Superintendent of Colombia, calculations by *Banco de la República*.

of 2022, more than two times the system's current level, for the aggregate capital adequacy to fall below 11%. In spite of the fact that the individual results by CI is quite mixed, the above implies that the system currently has a substantial cushion for dealing with losses from loan-loss provision costs and the lower income from interest that a deterioration in loan quality could cause.

2.5.3 Non-banking Financial Institutions

As of March 2021, assets of non-banking financial institutions (NBFI) in their proprietary account, which represented 5.0% of the financial system's total assets, registered a downturn and expanded at a pace that was lower than the average in recent years. This was driven mainly by the performance of the assets of the stockbroker firms' (SBF), trust fund companies (TC), and insurance companies which, together, account for 92.7% of the total assets in proprietary accounts (Graph 2.25, panel A). The decline seen in SBF assets is mainly due to the sharp loss of value of their investments. Regarding the portfolio managed by NBFI, its volume represents 52.2% of the financial system's total assets. The growth rate of the managed portfolio declined mainly because of SBF and TC which represent 68.1% of the total assets under management (Graph 2.25, panel B).

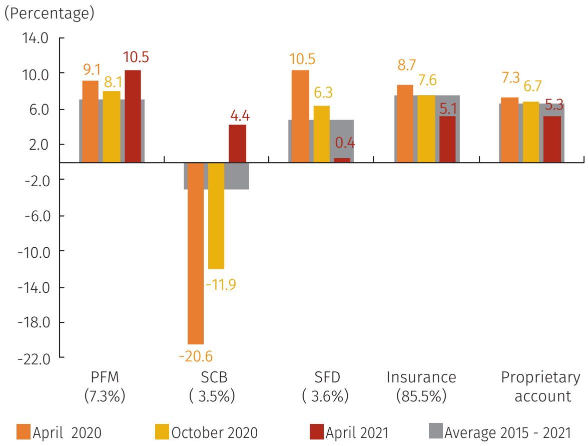
Assets of open-ended collective investment funds with no long-term agreement (CIF), which had grown for six months by the end of 2020, have been declining since February 2021 due to investor withdrawals. After the coronavirus shock, total CIF assets increased, reaching their highest historical level in February 2021. Although total assets are close to the minimum seen at the end of March 2020, recent declines have occurred in a span of seventeen weeks, as opposed to what happened during the pandemic crisis which took place in just two weeks (Graph 2.26).

Under current conditions, the exposure of NBFIs and CIs to sudden changes in prices and conditions in the TES markets becomes relevant in view of the lower demand for risky assets that could arise in the event of an increase in the medium and long-term interest rates in global financial markets. Exposure of NBFIs and Cis to fixed and variable income markets measured as an investment in securities exposed to market risk[45] is mainly concentrated in TES. Both CIs and NBFIs registered significant growth in holdings of public debt securities at the end of May 2021 while private debt securities showed contractions (Table 2.4). Given the above, and in view of the lower appetite for risk that could arise from the increase in medium and long-term interest

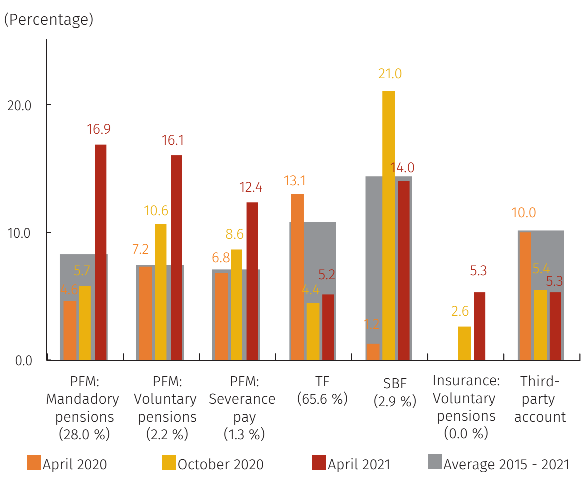
45 This balance is at market prices and is calculated according to the guidelines of the Basic Accounting and Financial Circular. The balance in shares was analyzed for the equity instruments of domestic issuers while, for debt securities, the ones that are marketable and available for sale were analyzed.

Graph 2.25
Assets of Non-banking Financial Institutions

A. In proprietary account

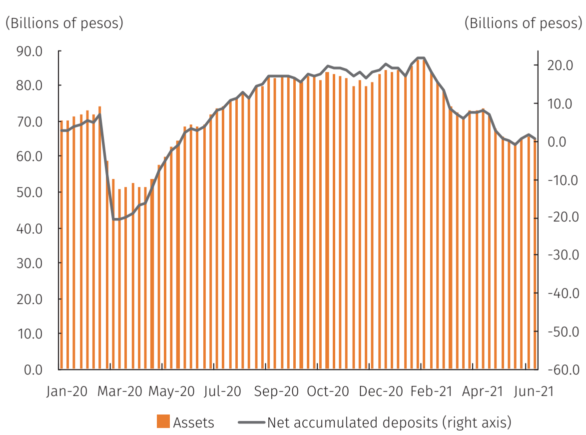


B. In Third-party Account



Source: Office of the Financial Superintendent of Colombia, calculations by *Banco de la República*.

Graph 2.26
Total Assets of Collective Investment Funds



Source: Office of the Financial Superintendent of Colombia, calculations by *Banco de la República*.

rates in global financial markets, the exposure of financial entities to sudden changes in prices and conditions in the TES markets becomes more relevant.

2.6 Performance and Outlook for Fiscal Situation

The increased public spending required to mitigate the adverse impact of the pandemic coupled with the negative shock to the nation's revenue resulted in an unprecedented deterioration in public finances. During 2020, the government, like the great majority of the countries around the world, faced a double impact on their finances during 2020. The shrinking of economic activity meant a COP 17.7 trillion reduction in CNG tax revenue compared to 2019 while the additional emergency expenditures came to almost COP 21 t. In addition, there was a COP 8 t increase in pension transfers mainly due to the adverse impact of the pandemic on the labor market that resulted in lower revenue for Colpensiones from pension contributions and the government's measures to temporarily and voluntarily reduce the percentage of pension contributions (Decree 558/2020). As a result, the CNG's fiscal deficit went from 2.5% to 7.8% of the GDP between 2019 and 2020 making it the highest deficit since 1999 (Graph 2.27). This, together with the effect of the depreciation of the peso, led to a 14.5 pp increase in the ratio of public debt to output and reached 65% of GDP, which is also the highest since 1999 (Graph 2.28).

The CNG will continue to utilize the funds from the Emergency Mitigation Fund (FOME in Spanish) to help alleviate the impact of the pandemic. COP 10 t of the COP 18 t from FOME earmarked for this year had been allocated as of June 30. The main uses have been for household and business assistance programs and the purchase of Covid-19 vaccines. The Solidarity Income Program that grants COP 160.000 monthly to almost three million homes that receive no support from the State has FOME funds up to August of this year. The resources allocated to the Formal Employment Support Program (PAEF in Spanish), in turn, through which a payroll subsidy equivalent to 40% of the minimum wage (COP 351,000) per employee is provided to applicant companies and has contributed to sustaining close to four million jobs had been used as of June 2021. According to the Ministry of the Treasury and Public Credit, the Social Investment bill which was submitted to Congress on July 20, includes a budgetary addition to extend the duration of these two programs. Last of all, the government is moving forward with the procurement of vaccines against Covid-19 and using the funds available in FOME for this.

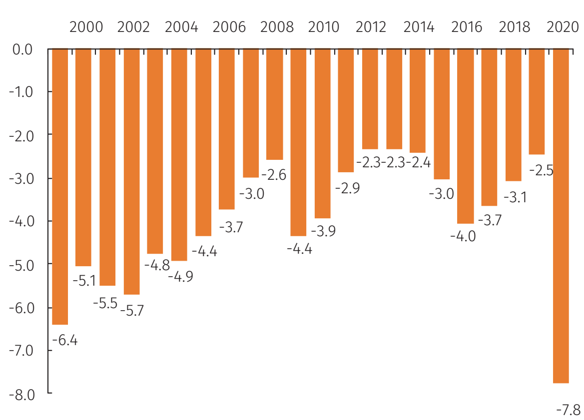
In 2021, public spending pressure continues to generate a larger deficit than in the previous year. The outlook for public finances is such that there is a need to approve a fiscal reform that will help ensure their sustainability in the medium term. This year, the recovery of productive

Table 2.4
Investment Balances Exposed to Financial Institution Market Risk

Type of Entity	TES[/a]	Private debt	Stocks	Total	TES	Private debt	Stocks	Total
	(balance in billions of pesos, June 2021)				(percentage change in the last six months)			
Credit Establishments	52.87	4.70	15.03	72.59	20.27	-0.26	17.45	18.11
Commercial banks	48.64	4.26	0.00	52.90	21.19	-3.37	0.00	18.76
Investment banks	3.44	0.25	14.99	18.69	7.98	31.58	17.19	15.55
Finance companies	0.78	0.14	0.02	0.94	23.61	69.63	494.12	30.92
Financial cooperatives	0.00	0.04	0.02	0.06	0.00	75.38	0.00	147.30
Non-banking Financial Institutions (NBFI)	12.08	10.82	6.48	29.38	15.60	-14.12	-1.05	-0.74
Pension Funds: proprietary position	0.25	0.88	0.13	1.27	-6.61	2.76	-5.68	-0.19
Stock Brokerage Firms in proprietary position	1.60	0.26	0.15	2.01	25.45	58.07	8.02	27.39
Trust Fund Companies in proprietary position	0.30	0.33	0.99	1.63	112.48	-20.36	-0.73	4.24
Insurance and Capitalization Companies	9.93	9.35	5.20	24.48	13.30	-16.26	-1.22	-2.83
System in Proprietary Position	64.94	15.52	21.50	101.97	19.37	-10.35	11.19	11.98
Managed Position								
Stock Brokerage Firms in third party position	1.96	10.68	8.42	21.06	55.53	-16.68	14.19	-1.82
Trust Fund Companies third party position[b/]	118.41	37.84	15.45	171.70	5.50	-13.88	5.45	0.51
System	185.32	64.04	45.37	294.73	10.37	-13.54	9.69	4.02

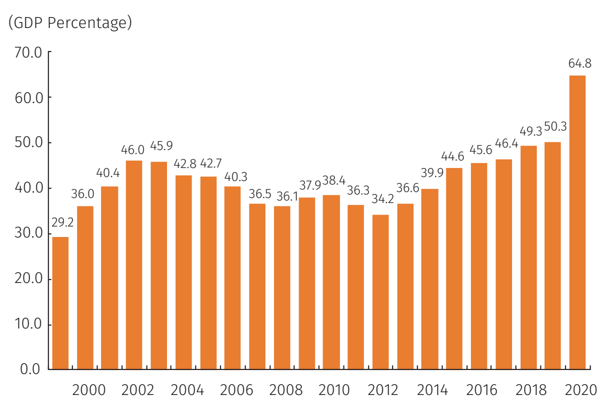
a/ The value of the proprietary position is obtained from "Investment Portfolio" on format 351. The value of the managed position is obtained from CSD data.
b/ Pension liabilities managed by trust companies are excluded.
Source: Central Securities Depository (CSD), Office of the Financial Superintendent of Colombia, calculations by *Banco de la República*.

Graph 2.27
Fiscal Deficit of the Central National Government (percentage of GDP)



Note: preliminary figures.
Source: Ministry of the Treasury and Public Credit) (DGPM)

Graph 2.28
Gross Debt of the Central National Government



Source: Ministry of the Treasury and Public Credit) (DGPM)

Table 2.5
Use of the Emergency Mitigation Fund (FOME) Resources
(billions)

Uses (committed resources)	2020	2021	2021 to june
1. Emergency health care	7,002	8,887	3,950
Expansion of supply / insurance / vaccination	6,108	3,885	3,785
Biosafety, supply, and others	894	435	165
Available resources with no defined use		4,566	
2. Care for vulnerable populations	8,575	5,181	3,759
Solidarity Income Program	4,343	4,055	2,986
Extra payments from previous social programs	3,645	1,078	751
Other transfers	586	48	22
3. Protection of employment and economic activity	6,455	4,006	2,023
Formal Employment Support Program	4,915	1,940	1,901
Commission subsidy of FNG guarantees	1,224	1,584	0
Other help	316	482	97
Total	22,031	18,073	9,732

Source: Ministry of the Treasury and Public Credit, FOME White Book June 2021.

activity will probably allow tax collection to recover and slightly surpass the level it had in 2019 (around COP 150 t). The above would not be enough to offset the expenditure for the health emergency that continues in 2021 (COP 18 t) and the increase (COP 10 t) in public investment compared to 2020 to contribute to economic reactivation. Based on the Medium-Term Fiscal Framework (MTFF) presented by the Ministry of the Treasury and Public Credit last June 15, the 2021 fiscal deficit will probably be 8.6% of the GDP (an estimate that is likely to be 0.9 pp higher than in 2020 and that incorporates the funds that could be raised from the divestment of ISA). Meanwhile, NG gross debt will probably reach 67% of GDP (2 pp higher than in 2020). These levels of indebtedness are relatively high and generate vulnerabilities in terms of the proper management of macroeconomic policies in an environment of economic recovery. The ability of monetary policy to maintain an expansionary stance may be reduced by shocks to macroeconomic variables derived from the fiscal policy stance. Therefore, in line with the government's plans presented in the MFMP, it is essential to move forward with a fiscal reform that, with structural adjustments in revenue, expenditures and the fiscal rule, will allow us to channel public finances along a trajectory towards consolidation that will contribute to their sustainability in the medium term.

03 / Foreign Reserves

In compliance with Act 31/1992, *Banco de la República* manages the foreign reserves in accordance with the public interest, to the benefit of the national economy, and to facilitate the country's payments abroad. Consequently, the law requires that investment of the reserve assets be done under the criteria of security, liquidity, and profitability. The security criterion under which the foreign reserves are managed in Colombia implies proper control of the risk to which the investments are exposed. In order to manage them within acceptable parameters and levels, the Foreign Reserves Committee of *Banco de la República*[46] defines strict limits on each of the different risks that the reserves are exposed to. In order to comply with the liquidity criterion, the Bank invests the foreign reserves in financial assets that are easy to liquidate or in assets with short-term maturities and defines investment tranches on the basis of liquidity and profitability objectives. Once the criteria are defined to ensure that the foreign reserves portfolio is invested at a low risk, the management policy also seeks to achieve a suitable return since this criterion is part of the mandate given to *Banco de la República* by law. An explanation of the policies that guide the investment of the reserves and some relevant definitions are provided in the Appendix.

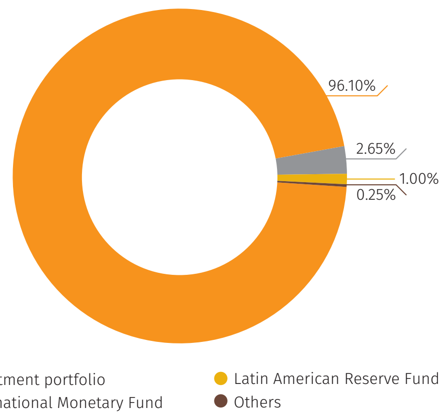
The main purpose of the foreign reserves is to protect the country from external shocks that may affect both trade and financial flows and, depending on their magnitude, may jeopardize macroeconomic stability. Trade flows may be affected, for example, by a drastic reduction in exports that makes it more difficult to pay for imports. Financial flows, in turn, may also be affected due to difficulties in getting access to foreign financing such as reduced access to international credit, or higher capital outflows from both foreigners and residents. A country's foreign reserves are a determining factor in the perceived creditworthiness of domestic borrowers. This is related to foreign lenders' belief that a suitable level of reserves will enable the residents to meet their obligations in foreign currency such as paying for imports and servicing the foreign debt at a time when the country faces difficulty in accessing foreign financing. Thus, an appropriate level of reserves contributes to improving the risk perception of the country and its residents, and this translates into better financing conditions abroad such as the payment of lower interest rates.

***Banco de la República* holds external liquidity buffers in amounts it considers sufficient to meet the aforementioned objective.** To this extent, the current strategy of accumulating foreign reserves is a recognition of the importance of having a proper level of liquidity in foreign currency to prevent and face external shocks.

The net foreign reserves showed a USD 113.4 million (m) decrease at the end of June 2021 due to the low profitability earned during the year. In line with expectations based on international financial conditions, this profitability has been considerably lower than in previous years. As of 30 June 2021, net foreign

46 The Foreign Reserves Committee is composed of the Minister of Finance or his delegate, the full-time members of the Board of Directors and the Governor.

Graph 3.1
Breakdown of the Gross Foreign Reserves
(information as of 30 June 2021)



Note: gold is included in the investment portfolio. The item "Others"" includes international agreements, cash on hand, and demand deposits.
Source: *Banco de la República*

reserves[47] amounted to USD 58,917.3 million. The return on the foreign reserves excluding the foreign exchange component was -0.01% (-USD 4.18 m).[48] The low return on the foreign reserves over the course of 2021 has been due to the low short-term interest rates in foreign financial markets and the depreciation of the investments as a result of the increase in medium- and long-term interest rates. The impact of the exchange rate effect on the valuation of the reserves explains the other part of the decrease in the foreign reserve level.

The main component of the foreign reserves is the investment portfolio. This corresponds to investments in financial instruments on the international market and to the certified physical gold (95.65% and 0.45% respectively of the reserves). The breakdown of the foreign reserves as of 30 June 2021 is presented in Graph 3.1.

3.1 Reserve Indicators

The foreign reserves, together with the IMF FCL, cover the estimated external liquidity buffers required by the country. In order to estimate foreign currency liquidity needs in an adverse scenario over a one-year horizon, *Banco de la República* follows the liquidity coverage ratio approach (LCR) of the Basel III supervisory framework for commercial banks. This approach stipulates that the liquid assets should be sufficient to cover liquidity needs for a predetermined period while taking the stressed scenario into account. *Banco de la República*'s methodology stipulates that the foreign reserves should cover at least the forecasts for the current account deficit plus the repayment of foreign debt for the next twelve months.[49] As of June 2021, the foreign reserves covered these items. The methodology also stipulates that the sum of the foreign reserves and FCL should cover the above items plus the possible outflows of residents' and non-residents' capital. The foreign reserves plus the FCL net of disbursements are currently higher than that level.

Supplementary indicators to evaluate foreign reserves showed appropriate levels for the country. The IMF has proposed a methodology (ARA)[50] for an appropriate level

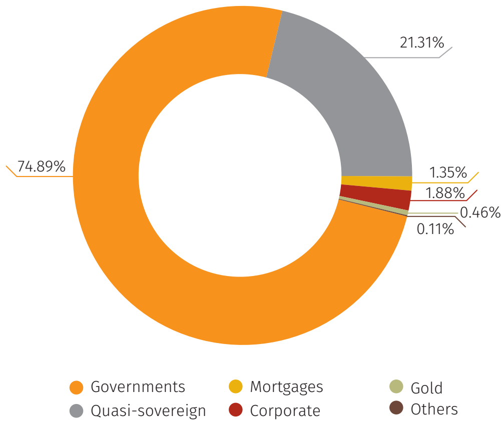
47 The net foreign reserves are equal to the total foreign reserves, or gross reserves, minus *Banco de la Republica*'s short-term foreign liabilities. The latter consists of obligations to non-resident agents in foreign cu-rrency. The gross foreign reserves came to USD 58,925.4 million and the short-term foreign liabilities totaled USD 8.16 m.

48 More information on the profitability of the foreign reserves can be found in section 3.3.

49 For more information on the methodology, see the shaded section: New methodology for determining the appropriate level of foreign reserves in the March 2019 Board of Directors' Report to the Congress of the Repu-blic.

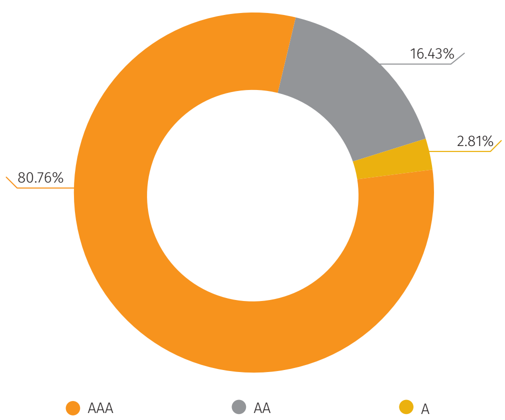
50 This acronym corresponds to *assessing reserve adequacy.*

Graph 3.2
Components of Investment Portfolio by Sector
(information as of 30 June 2021)



Source: *Banco de la República*

Graph 3.3
Distribution of Investment by Credit Rating
(information as of 30 June 2021)



Source: *Banco de la República*

of reserves that is intended to cover the main risks to the balance of payments by looking at macroeconomic variables[51] during periods when there is pressure on the exchange market. An economy is believed to be maintaining proper levels of reserves if the ratio of the reserves to the appropriate level is between 1.0 and 1.5. Based on figures as of June 2021, the ratio of IMF reserves to the appropriate level stood at 1.5.[52] An adaptation of this methodology[53] introduces some variations to reflect the characteristics of the Colombian economy. The ratio between the reserves and the appropriate level of this adaptation stood at 1.9 in June 2021. However, this indicator estimates outflows during a period in which Colombia has not experienced a crisis, since it takes data from the beginning of the floating exchange rate regime.

3.2 Breakdown of the Investment Portfolio[54]

As of June 2021, the investment portfolio was mainly invested in securities issued by governments and entities related to governments. The breakdown of the investment portfolio as of June 2021 can be seen in Graph 3.2 when about 96.20% was invested in securities issued by these entities.

The breakdown of the portfolio by rating shows the high credit quality of the investments. Graph 3.3 shows that 80.76% of the portfolio is invested in instruments rated AAA and 16.43% in AA. The Bank uses the lowest investment grade rating granted by at least two of the three main rating agencies (S&P, Moody's, and Fitch Ratings) as a benchmark.

The investment portfolio is made up of currencies that are characterized by their high daily trading volumes and that belong to countries with elevated credit ratings. The United States dollar is the currency with the highest share. Graph 3.4 shows the foreign exchange breakdown of the investment portfolio as of 30 June 2021. The largest share of Colombia's foreign reserves is in US dollars due to the fact that a majority of the country's commercial and financial

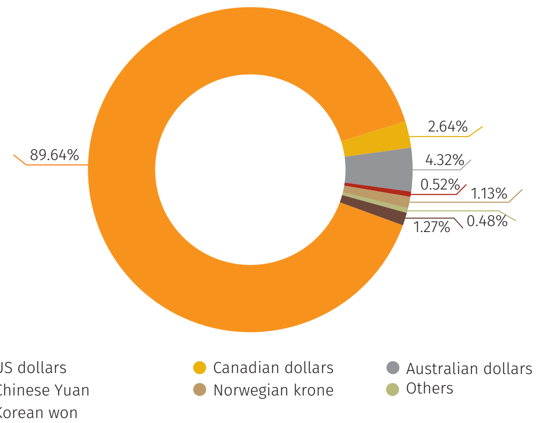
51 The first risk is associated with a loss of access to external financing and is captured by short-term debt. The second is associated with a loss of confidence in the local currency and is measured by a monetary aggregate. The third is associated with a reversal of the capital flows that finance the deficit in the current account and is quantified on the basis of the portfolio liabilities of the international investment position. Last of all, the volume of exports is incorporated to capture a possible collapse of demand from abroad – IMF (2015). "Assessing Reserve Adequacy: Specific Proposals."

52 The calculation was done with the IMF's ARA methodology and figures from *Banco de la República*.

53 Gómez and Rojas (2013). "Assessing Reserve Adequacy: The Colombian Case," *Borradores de Economía*, no. 781, *Banco de la República*.

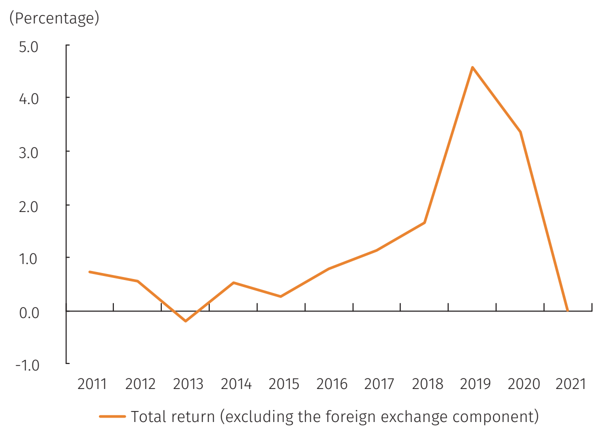
54 The graphs of the breakdown of the portfolio by currency and credit rating were calculated based on the amount in the investment portfolio excluding the gold.

Graph 3.4
Foreign Exchange Breakdown of the Investment Portfolio (information as of 30 June 2021)



Source: *Banco de la República*

Graph 3.5
Historical Profitability of the Foreign Reserves[a/]
(information as of 30 June 2021)



a/ The return for 2021 corresponds to the year-to-date figure as of June 30. For the other years, the figures show the profitability obtained throughout the year.
Source: *Banco de la República*

transactions with the rest of the world are carried out in this currency. Investment in the following currencies is also allowed: Canadian, Australian, New Zealand dollars; Swedish krona; the pound sterling; Swiss frank; euros; yen; Norwegian krone; the renminbi; Hong Kong and Singapore dollars, and Korean won.

3.3 Profitability of the Reserves

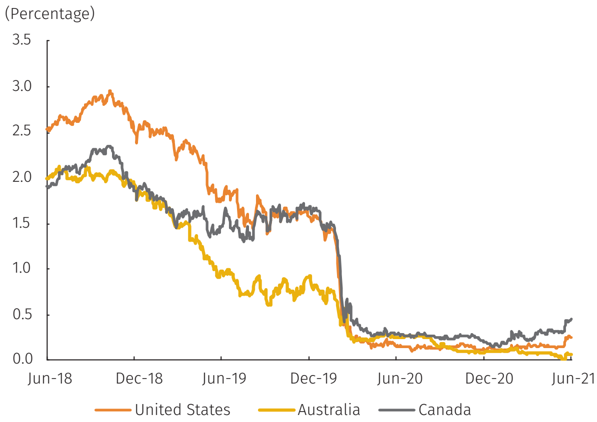
The profitability of the reserves depends primarily on two factors: interest and appreciation. The first corresponds to the interest received from the instruments invested in, while the appreciation factor corresponds to the change in the prices of the securities due to movements in the interest rate. The second factor occurs because there is an inverse relationship between bond prices and interest rates: , the price of the bonds declines as the interest rates rise, and vice versa.

In line with the expectation of a considerable reduction in the profitability of foreign reserves in 2021, they showed a profitability of -0.01% as of June 30.[55] This is due to the low short-term interest rates prevalent in international financial markets and to the fact that investments have been devalued as a result of the increase in medium and long-term interest rates. The historical profitability of the foreign reserves is presented in Graph 3.5. Exceptionally high levels of profitability were seen in the foreign reserves in 2019 and 2020 due to the appreciation of investments in response to the decrease in interest rates (appreciation factor). Specifically, the measures taken by the authorities during those two years in reaction to the global economic slowdown and as a result of the economic effects of the pandemic, led to an accelerated fall in short-term interest rates in the United States and other markets relevant to the portfolio. These are currently at levels close to zero. This rapid decrease in interest rates favored the profitability of foreign reserves during this period but has generated lower interest on investments (interest factor) so far in 2021. Furthermore, the medium and long-term interest rates in the main markets in which the reserves are invested have risen over the course of the year as a result of the expectations of a rapid global economic recovery and thus generated devaluations in the investments (appreciation factor).

In line with what was seen in the first half of the year, the return on the foreign reserves during the second half of 2021 is expected to remain at low levels. With interest rates in the markets where the reserves are invested at near-zero levels, the interest received will be very low (interest

55 This profitability is obtained by dividing the profitability by the average value of the net reserves on 31 December 2020 and on 30 June 2021. Since 2015, the impact of the exchange rate effect on the profitability of the reserves has been excluded.

Graph 3.6
Short-term Government Bond Rates (2 years)
(information as of 30 June 2021)



Source: *Banco de la República*

factor), and there is no prospect of appreciations from additional rate reductions in the short term (appreciation factor). The sudden drop in the interest rates for portfolio assets and corresponding increase in their prices led to the receipt of a profit in 2020 that had been expected to be achieved over a longer period of time under stable conditions. Thus, the drastic reduction in the interest the portfolio assets receive will generate a decrease in future profitability. In addition, the possibility of additional returns as a result of further interest rate declines seems lower now than during previous periods. As can be seen in Graph 3.6, the interest rates in the markets that are relevant to the reserve investment have reached near-zero levels and, at the moment, are not expected to reach negative levels.

3.4 Measures to Reinforce International Liquidity

Foreign reserves as a source of external liquidity are complemented by the IMF's FCL resources. In April this year, the Board of Directors of the Fund did an mid-term review of our country and confirmed that Colombia continues to meet the qualification criteria for access to this facility.[56] In its evaluation, the IMF Board highlighted Colombia's economic policy response to the crisis, its very strong economic policy framework, and its policy implementation capability. The IMF communiqué notes that the framework of flexible exchange rate within a credible inflation targeting regime, an effective supervision and regulation of the financial system, and a sustainable fiscal policy enabled the country to provide a coordinated response in a suitable time frame to the largest recession on record given the Covid-19 pandemic. It also notes that this sound policy framework has enabled the authorities to support the gradual recovery process.

The FCL is an instrument designed to cover external and tail risks of countries with sound fundamentals and very strong economic policy frameworks. Access to this instrument is justified insofar as Colombia has a strong track record that builds confidence that the country will continue to pursue sound economic policies. In that mid-term review, the IMF Board assessed Colombia's compliance with the following conditions: 1) a sustainable external position, 2) a capital account in which private flows dominate as a financing source, 3) a track record of sovereign access to international capital markets under favorable terms, 4) a level of reserves that remains adequate, 5) sound public finances and a sustainable situation in terms of public debt, 6) a low and stable inflation in the context of a solid

56 The IMF's communique is available at: https://www.imf.org/es/News/Articles/2021/04/29/imf-executive-board-concludes-review-of-colombia-flexible-credit-line-arrangement. The document with the mid-term evaluation is available at: https://www.imf.org/en/Publications/CR/Issues/2021/05/04/Colombia-Review-Under-the-Flexible-Credit-Line-Arrangement-Press-Release-Staff-Report-and-50182

monetary and foreign exchange policy framework; 7) a sound financial system and the absence of solvency problems that may threaten systemic stability, 8) effective financial sector oversight and 9) data integrity and transparency. The characteristics of the FCL itself generate financing features that are: 1) contingent, which means that it covers the country against extreme scenarios, 2) immediate availability, i.e., the funds are immediately available to countries with an FCL in place, and 3) without *ex post* conditionalities in the event of a disbursement from the instrument, which generates very favorable conditions for the country as an insurance mechanism and a complement to the external liquidity cushions. Thus, the instrument becomes consolidated as insurance against high external risks, preserves agents' confidence in the Colombian economy, and facilitates the country's access to international financial markets under favorable conditions. The next evaluation of compliance with the nine aforementioned conditions for eligibility to access to the FCL facility will take place in the first half of next year provided that the Colombian authorities decide to request a renewal of the instrument, which is in effect until 30 April 2022. At present, only Mexico, Chile, Peru, and Colombia are beneficiaries of an FCL.

The authorities have stated that the amount remaining after last year's IMF disbursement to the national government will be kept for precautionary purposes since they consider it a useful tool for reinforcing the Colombian economy's ability to deal with external shocks.[57] The FCL amounts to USD 17.6 billion that includes the disbursement of approximately USD 5.4 billion to the national government which was made in December 2020 for budgetary purposes. The remaining balance, which amounts to USD 12.2 billion, will be retained on a precautionary basis. This means that it will supplement foreign reserves as a foreign liquidity cushion and strengthen the country's international liquidity position. The authorities have recognized the transitory nature of the FCL and are committed to reducing the level of access if the situation of external risks improves.

Banco de la República **has access to the Federal Reserve repo facility (FIMA).** With this facility, FIMA account holders (central banks and other international monetary authorities with accounts at the Federal Reserve Bank of New York) are allowed to exchange their U.S. Treasury bonds held in custody at the Federal Reserve for U.S. dollars with the commitment to repurchase the securities the next day and pay the interest. The primary benefit that access to the FIMA repo facility has for *Banco de la República* is to have immediate liquidity in US dollars without having to sell off the assets of the foreign reserves portfolios permanently. This access mitigates the liquidity and market risk. *Banco de la República* would make use of this repo facility only in the event that, at the time it decides to sell dollars on the spot market, the market for buying and selling Treasury bonds turns out to be illiquid.

Another factor of global support that may benefit the country's international position is the proposed allocation of the IMF's SDR[58] **that was recently approved by the Fund's Board of Directors and will be ratified in August by the**

57 For more information on the FCL, the increase in it, and the disbursement made to the national government in 2020, see Box 2 of the previous edition of this *Report*.

58 For more information on the SDR, see: https://www.imf.org/en/About/FAQ/special-drawing-right.

IMF's Board of Governors.[59] The current allocation, which was initially planned for 2020, amounts to USD 650 billion (SDR 453 billion). Its main objective is to increase countries' reserve assets following the Covid-19 pandemic. The allocation seeks to rebuild global buffers, alleviate member countries' liquidity problems and, thus, support the stability of the global economy. The allocation for member countries is proportional to their quota in the Fund. Colombia could potentially receive USD 2.8 billion, i.e., SDR 1.9 billion, which would boost the country's international liquidity position.

59 For more information on the approval of the proposal go to: https://www.imf.org/en/News/Articles/2021/07/08/pr21208-imf-managing-director-kristalina-georgieva-executive-board-backing-new-us650b-sdr-allocation

04 / Financial Situation of *Banco de la República*

During the first half of 2021, the Bank's income statement (P&L) registered a profit of COP 524 billion (b) which contrasted with the exceptionally high results registered during the same periods in 2019 and 2020. This value was COP 6,410 b lower than in the January-June 2020 period. The above is mainly due to the lower return on the foreign reserves that resulted from the low foreign interest rates.

To the extent that foreign interest rates are at near-zero levels, there are no prospects for reductions that could be reflected in appreciations of the foreign reserve portfolio. By contrast, it is estimated that the Bank will generate losses in 2021 as a result from the eventual (possible/expected) devaluation of the securities in which the foreign reserves are invested because of the increase in interest rates abroad. Note that these reserves represent the Bank's largest asset,[60] and their yield is the main factor underlying the Bank's P&L results.

4.1 Financial Position of *Banco de la República* (balance sheet)[61]

As of June 30, 2021, the Bank's assets amounted to COP 261,148 b which is equivalent to the value of the liabilities (COP 164,417 b) plus equity (COP 96,731 b). From the beginning of the year up to the end of June, there was an increase in the Bank's balance sheet due mainly to the higher exchange rate. Since the gross foreign reserves are the main asset of *Banco de la República*, the depreciation of the peso against the reserve currencies had a significant effect on the institution's assets and, consequently, on its equity. At the end of June 2021, compared to the end of the previous year, assets had risen COP 12,206 b (4.9%), liabilities COP 2,249 b (1.4%) and equity COP 9,957 b (11.5%) (Table 4.1).

The increase in assets is explained by the higher value of foreign reserves in pesos that resulted from the depreciation of the peso with respect to reserve currencies. This was partially offset by the decrease in the TES portfolio. The balance of the gross foreign reserves in pesos increased COP 18.230 b (9.0%) mainly because of the depreciation of the Colombian peso with respect to the reserve currencies (COP 18,423 b). During the first half the year, the Bank did not make any purchases or sales of foreign currencies on the market.[62] The decrease in the TES portfolio (COP 10,684 b) was mostly due to the sales made on the market during March and April (COP 5,921 b) and by the delivery of TES

60 They accounted for more than 80% of total assets over the last ten years.

61 In this section, the line items are shown by economic rather than by accounting criteria. With respect to the financial statements presented to the Financial Superintendency of Colombia and the National General Accounting Office, the differences are: first, the value of the liabilities associated with purchase transactions for the foreign reserves portfolio for which payment has not yet been made is discounted from the assets (this is registered as a higher value of the asset in the Bank's financial statements and as a requirement of the foreign reserves under liabilities). Second, the coins in circulation, which are not part of the accounting information on the Bank's balance sheet, are included in the assets and liabilities in this section. And third, other reclassifications of lower value accounts. In this respect, the asset and liability values presented in this Report (COP 261,148 b and COP 164,417 b respectively) differ from those registered in the financial statements as of 30 June 2021 (COP 267,293 b and COP 170,562 b respectively).

62 Only the Non-Delivery Forward contracts for the sale of dollars were renewed during January and February. These renewals amounted to USD 181.8 million, USD 90.9 million per month.

Table 4.1
Financial Position Statement of *Banco de la República* Classified by Economic Criteria
(billions of pesos)

Accounts	December 2020		June 2021		Change	
	Balance	Share Percentage	Balance	Share Percentage	Absolute	Percentage
Assets	248,942	100.0	261,148	100.0	12,206	4.9
Gross Foreign Reserves	202,653	81.4	220,882	84.6	18,230	9.0
Share in international entities and organizations	10,126	4.1	10,368	4.0	242	2.4
Investments	26,214	10.5	13,214	5.1	-13,000	-49.6
TES	21,088	8.5	10,404	4.0	-10,684	-50.7
Private debt securities	5,126	2.1	2,810	1.1	-2,316	-45.2
Resale agreements: transitory liquidity support	4,679	1.9	11,462	4.4	6,783	145.0
Other net assets	5,271	2.1	5,222	2.0	-49	-0.9
Liabilities and equity	248,942	100.0	261,148	100.0	12,206	4.9
Liabilities	162,168	65.1	164,417	63.0	2,249	1.4
Foreign-currency liabilities that affect foreign reserves	29	0.0	30	0.0	2	5.6
Monetary Base	132,674	53.3	128,593	49.2	-4,080	-3.1
Cash	94,456	37.9	95,025	36.4	569	0.6
Reserve	38,217	15.4	33,568	12.9	-4,649	-12.2
Interest-bearing deposits not constituting reserve requirements	2,864	1.2	1,219	0.5	-1,645	-57.4
Other deposits	49	0.0	56	0.0	6	12.8
National Government-National Treasury Office L/C	14,485	5.8	22,048	8.4	7,563	52.2
Obligations to international organizations	12,067	4.8	12,471	4.8	404	3.3
Total equity	86,774	34.9	96,731	37.0	9,957	11.5
Capital	13	0.0	13	0.0	0	0.0
Reserve	0	-	764	0.3	764	n.a.
Surplus	78,703	31.6	96,828	37.1	18,124	23.0
CEC settlement	521	0.2	521	0.2	0	0.0
Exchange rate adjustment of the foreign reserves	77,854	31.3	95,973	36.8	18,119	23.3
Investment in assets for cultural activities	329	0.1	334	0.1	5	1.6
Other comprehensive income (OCI)	879	0.4	-1,179	-0.5	-2,058	n.a.
Fiscal year result	7,483	3.0	524	0.2	-6,959	-93.0
Cumulative results: effect of change in accounting policies	-242	-0.1	-188	-0.1	54	-22.5
Accumulated Results: Process of Convergence with IFRS	-61	-0.0	-31	-0.0	31	-50.0

Source: *Banco de la República*

to the national government at market prices as a part of the payment of the 2020 profits to be distributed (COP 3,506 b)[63] and, to a lesser extent, by the negative valuation at market prices of COP 902 b and finally, by the COP 354 b in coupon payments. Furthermore, the balance of temporary liquidity operations (expansion repos) rose COP 6,783 b while the private debt portfolio held by the Bank decreased COP 2,316 b, mainly because of the maturities of these securities.[64]

Liabilities, in turn, rose due to the government deposits at the Bank. These were partially offset by the decrease in the monetary base and by the balance of interest-bearing deposits not constituting reserve requirements. During the first half of 2021, the national government's peso deposits in the Bank rose COP 7,563 b[65] while the monetary base and the balance of interest-bearing deposits not constituting reserve requirements decreased COP 4,080 b and COP 1,645 b respectively.

Last of all, the equity rose, mainly due to the foreign exchange adjustment account. This account had a change of COP 18,119 b[66], reflecting the higher value in the peso balance of the gross foreign reserves. The above was partially offset by the transfer of profits to the national government the 2020 COP 6,629 b earnings, and by the lower value in other comprehensive income account (OCI) of COP 2,058 b. Note that, in 2021, reserves of COP 764 b were set aside against 2020 earnings.[67] From the start of the year to June, income for the year amounted to COP 524 b.

4.2 Income Statement (L&P)

4.2.1 Close of June 2021

During the first half of 2021, *Banco de la República*'s profits came to COP 524 b as a result of COP 1,345 b in income and COP 821 b in expenditures (Table 4.2). With respect to the January-June 2020 period, there were annual declines in income for COP 6,849 b (-83.6%) and in expenditures for COP 439 b (-34.8%).

The income during 2021 is mainly due to the return on the securities denominated in national currency held by the Bank (TES and private debt), the differences in the foreign exchange rate, and corporate income. The yield on the national currency-denominated securities held by the Bank, was COP 861 b (COP 758 b in TES and COP 103 b in private debt securities), COP 53 b higher than the earnings during the January-June 2020 period. The TES income in the first half of 2021 was COP 185 b higher than what had been seen a year earlier and mainly resulted from the realized value coming from price changes that were a consequence of portfolio sales and the transfer of part of the Bank's profits to

63 Pursuant to the provisions of Act 2063/2020 article 26. See https://www.banrep.gov.co/es/el-banco-republica-paga-parte-las-utilidades-del-ano-2020-nacion-tes

64 As of June 2021, the balance of temporary liquidity transactions amounted to COP 11,462 b, and private debt securities held by the Bank amounted to COP 2,810 b.

65 See the shaded section on monetary base and M3.

66 This includes the valuation by foreing exchange differences of the obligation of the IMF allocations and the Andean pesos with FLAR.

67 Of this amount, COP 583 b corresponded to the foreign exchange results reserve and COP 181 b to the foreign exchange stabilization reserve.

Table 4.2
Banco de la República's Income Statement (January to June)
(billions of pesos)

	Actual as of June		Annual changes	
	2020	2021	Absolute	Percentage
1. Total Income (A+B+C)	8,194	1,345	-6,849	-83.6
A. Monetary income	8,040	1,125	-6,915	-86.0
1. Interest and returns	7,772	950	-6,822	-87.8
Foreign Reserves	6,083	-9	-6,091	n.a.
Private Debt Securities Held by *Banco de la República*	234	103	-132	-56.1
TES Held by *Banco de la República*	573	758	185	32.2
Expansion repos	156	68	-88	-56.3
Foreign Exchange Regulation Transactions	726	29	-696	-95.9
2. Foreign exchange differences	268	175	-93	-34.8
3. Other monetary income	0	0	0	343.8
B. Coins issued	44	105	60	136.3
C. Corporate income	110	115	5	4.7
II. Total expenditures (A+B+C+D)	1,260	821	-439	-34.8
A. Monetary expenditures	840	386	-453	-54.0
1. Interest and returns	753	276	-477	-63.4
Government Interest-bearing Deposits	449	191	-257	-57.3
Monetary contraction deposits	55	35	-20	-36.5
Foreign Exchange Regulation Transactions	249	49	-200	-80.3
2. Costs of Management and of Funds Managed Abroad	22	24	2	10.5
3. IMF Flexible Credit Line Commitment Fee	49	69	20	41.0
4. Foreign exchange differences	16	17	2	11.5
5. Other monetary expenditures	0	0	0	8.4
B. Banknotes and coins	85	89	4	4.6
C. Corporate expenditures	335	341	6	1.8
1. Personnel costs	215	223	7	3.4
2. Overhead	56	56	0	0.8
3. Other Corporative	64	63	-2	-2.7
Flexible budget availability	0	0	0	n. a.
D. Pensioners' expenses	0	4	4	n. a.
III. Fiscal year result (I - II)	6,934	524	-6,410	-92.4

n.a. Not applicable
Source: *Banco de la República*

the government in TES.[68] In the case of COP 103 b in income from private debt securities, this was the result of interest accrued at the purchase interest rate (purchase IRR) of this portfolio held by the Bank. As for the income generated by exchange rate differences, its value at the end of June 2021 was COP 93 b lower compared to what had been seen a year ago.[69] With regard to corporate income,[70] its value during the first half of 2021 was COP 115 b, which was COP 5 b higher than what was seen during the same period in 2020. Note that the main difference compared to the January-June 2020 period was the yield of foreign reserves[71] that showed a negative result of COP 9 b. This was COP 6,091 b lower than the result seen in the first half of 2020 (Table 4.3).

Table 4.3
Return on Foreign Reserve Investments
(billions of pesos)

	Actual as of June	
	2020	2021
Returns	6,083	-9
Investment portfolio	5,667	-79
Accrual of interest	1,638	1,391
Valuations at market prices	4,029	-1,470
Gold	360	-58
International entities and organizations	55	128

Source: *Banco de la República*

The outlays, in turn, are primarily due to the remuneration paid on the national government's deposits and the performance of corporate expenditures. The monetary expenditures[72] were COP 386 b for the first half of 2021 and included the remuneration on the government deposits by COP 191 b. These were COP 257 b lower with respect to the value registered during the same period in 2020 and resulted from a lower average balance and a lower rate of remuneration. Regarding the corporate outlays, these amounted to COP 341 b with an annual increase of COP 6 b (1.8% which is equivalent to -0.2% in real terms) of which: 1) personnel costs, COP 223 b, rose 3.4% per year (1.3% in real terms); 2) the overhead, COP 56 b, registered an annual change of 0.8% (-1.2% in real terms), and 3) other corporate expenses, COP 63 b, presented an annual decrease of -2.7% (-4.7% in real terms). The reduction in other corporate expenses was primarily due to the decrease in expenditures

68 When the Bank registers debt securities in its assets, the appreciations from changes in their market prices are registered in the account other comprehensive income (OCI) without affecting profit. If the Bank liquidates portfolio (due to sales or transfer of profits to the government) the accumulated gains within the OCI are transferred to the P&L thereby registering an increase in income from interest and yields on securities.

69 When the peso depreciates *vis-à-vis* in relation to the US dollar, the income from the foreign exchange differences that result from the higher value, in pesos, of foreign currency assets other than foreign reserves is registered on the Bank's P&L. The higher the depreciation of the peso is, the greater the value of this revenue. During the first half of 2020, COP 268 b in income from foreign exchange differences was registered that resulted from a 14.62% depreciation of the peso compared to the dollar. For the same period in 2021, income from the same source was lower due to smaller depreciation of the peso with respect to the dollar (9.21%).

70 They mainly include income from commissions for banking services and trust business, interest on loans to employees and pensioners, leases, social welfare activities, and income from cultural activities.

71 The effect of the foreign exchange differential on foreign reserves due to changes in the dollar exchange rate vs. other currencies in which these reserves are invested is registered in the Bank's OCI account and has no effect on the P&L.

72 These mainly include expenses related to remuneration of government deposits and the monetary tightening transactions, the management and administration of funds abroad, the commitment fees for the flexible credit line with the IMF, and exchange rate differences. It also included losses on some Non-Delivery Forward contracts and swaps with unfavorable results to the Bank in 2020 and 2021.

related to the management of the Savings and Stabilization Fund (FAE Trust)[73] and the effect of the donation of Casa Bolivar to the Ministry of Culture in 2020.

4.3 Outlook for 2021

A loss of COP 22 b is projected for 2021 which contrasts with the positive results registered in 2020.[74] The result projected for 2021 is the proceeds of COP 1,786 b in income and COP 1,808 b in spending (Table 4.4).

With respect to monetary results, a net income of COP 549 b is estimated. The projection for 2021 assumes an 86.4% annual decrease in revenue compared to what was seen in 2020, mainly because of the lower return of COP 6,962 b projected for the foreign reserves. Interest income from national currency-denominated securities held by the Bank is estimated to be COP 1,221 b (COP 1,064 b in TES, and COP 157 b in private debt securities). This is lower than what was seen in 2020 and resulted from the Bank's portfolio sales, the transfer of profits in TES to the government, and the maturities of securities. The main monetary outlays correspond to the interest payments on government deposits that are expected to be COP 412 b which is COP 365 b lower than what was seen in 2020 and will be the result of both the lower average balance and the lower interest of remuneration.

A net outflow of COP 24 b is expected with regards to putting banknotes and coins into circulation. Income from the face value of the currency issued is estimated at COP 269 b with an annual increase of 56.9% resulting from the higher demand for coins. As a result of the Covid-19 health emergency, the demand for coins was affected in the first half of 2020 mainly by the limited activity in sectors such as retail trade, urban transportation, and tolls. The costs of issuing and putting monetary species into circulation, in turn, are projected to be COP 292 b, which is 35.5% higher than what was seen in 2020, due to the greater demand for coins mentioned above.

With respect to the corporate budget and expenditures on pensioners, COP 547 b in net outlays is expected. COP 227 b in income and COP 775 b in spending is estimated (annual changes of 2.7% and 13.1% respectively compared to what was seen in 2020). The growth in corporate expenses is mainly due to the provisions in the Bank's Collective Agreement (CCT in Spanish)[75] and the higher expenses resulting from technology projects, maintenance, repairs and modifications, debt repayment, depreciation, and impairment, etc. Particularly, the higher spending on technology projects is related to the change in business model based on which contracts for licensing (investment expense) are being replaced by subscriptions in the cloud (P&L expenditure). Note that the increase in corporate expenditures is also related to the lower base of comparison to 2020 when some of them could not be implemented because of the Covid-19 pandemic effect.

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73 The decline in these expenses was due to the lower value of the portfolio managed in 2021 because of the COP 12,100 b loan made to FOME (Emergency Mitigation Fund) from this fund, Decree 444/21 March 2020.

74 Profits for 2020 came to COP 7,483 b. The loss in the budget approved for 2021 was COP 122 b.

75 An annual salary increase for Bank employees equal to the inflation target plus 2 pp (except those excluded from this agreement) is considered in the Bank's CCT.

Table 4.4
Forecast for *Banco de la República's* 2021 Income Statement
(billions of pesos)

	Actual	Projection	Annual changes	
	2020	2021	Absolute	Percentage
I. Total Income (A+B+C)	9,863	1,786	-8,077	-81.9
A. Monetary income	9,471	1,290	-8,180	-86.4
Interest and returns	9,365	1,128	-8,237	-88.0
Foreign Reserves	6,635	-327	-6,962	n. a.
TES Held by *Banco de la República*	1,133	1,064	-68	-6.0
Private Debt Securities Held by *Banco de la República*	309	157	-152	-49.2
Expansion repos	241	204	-37	-15.4
Foreign Exchange Regulation Transactions	1,047	29	-1,018	-97.2
Foreign exchange differences	105	153	48	45.5
Other monetary income	0	9	9	6.123.5
B. Coins issued	171	269	97	56.9
C. Corporate income	221	227	6	2.7
Commissions: Banking services and Fiduciary operations	192	198	6	3.4
Other corporate income	29	29	-1	-1.8
II. Total expenditures (A+B+C+D)	2,380	1,808	-573	-24.1
A. Monetary expenditures	1,480	741	-739	-49.9
Interest and returns	1,318	497	-821	-62.3
National Government's Interest-bearing Deposits	777	412	-365	-47.0
Liability transaction deposits for monetary regulation	77	37	-40	-52.4
Foreign Exchange Regulation Transactions	465	49	-416	-89.5
Costs of Management and Handling of Funds Abroad	60	66	6	10.1
IMF Flexible Credit Line Commitment Fee	98	138	40	40.9
Foreign exchange differences	3	38	35	1.070.7
Other monetary expenditures	1	1	0	60.2
B. Banknotes and coins	216	292	77	35.5
C. Corporate expenditures	676	762	85	12.6
Personnel costs	432	469	37	8.5
Overhead	125	154	29	23.4
Other Corporative	119	135	16	13.1
Flexible budget availability	0	4	4	n. a.
D. Pension payments	8	13	5	56.1
III. Fiscal year result (I - II)	7,483	-22	-7,504	n. a.

n.a. Not applicable
Source: *Banco de la República*

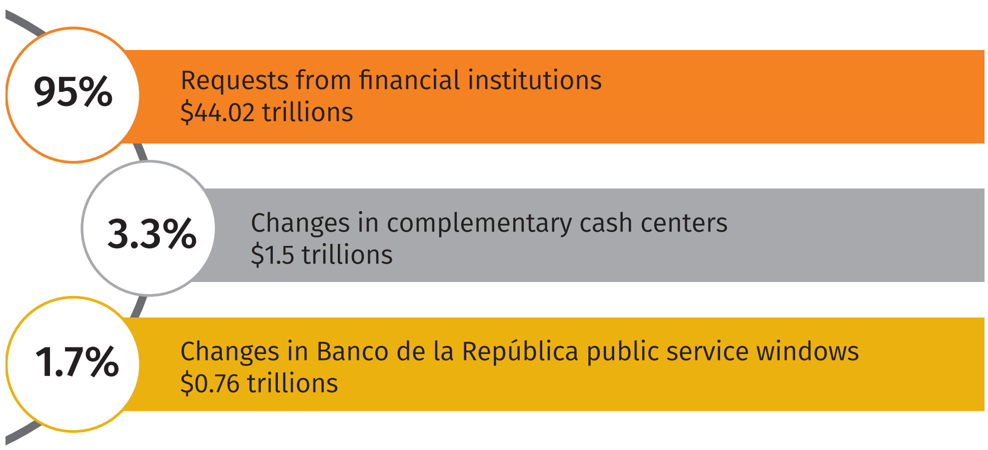
05 / Payments in the Colombian Economy

As a result of the pandemic, the demand for cash rose during 2020. In accordance with its legal mandate, Banco de la República met this increase by providing cash in the quantity and quality demanded by the economy. Electronic payments from individuals and corporations remained relatively stable during 2020. The increase in wire transfers offset the decrease in card (credit and debit) and check payments. With regard to the retail payment system, Banco de la República *took part in defining a new regulation that is intended to encourage access, transparency, integrity, stability, efficiency, innovation, and interoperability as well as protect the interests of the users of these payment services. Banco de la República also continued contributing to the smooth functioning of the payment system through the ongoing provision of the services of the large-value payment system, the deposit accounts (CUD), the Central Securities Depository (CSD), the Automated Clearing House (ACH Cenit), and the Clearinghouse for Checks (Cedec).*

5.1 Cash provision demanded by the economy

Banco de la República **has the exclusive constitutional function that cannot be delegated of issuing the legal currency and, consequently, it prints, mints, distributes, and destroys the monetary species.** The provision of banknotes and coins required by the economy for transactions is handled by three distribution channels (Diagram 5.1):

Diagram 5.1
Cash Outflows from *Banco de la República (in 2020)*

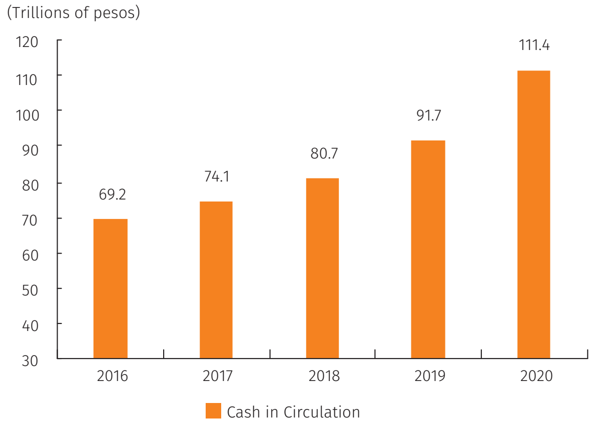


Source: *Banco de la República*

i. Financial entities that withdraw cash against their deposit account (CUD) at *Banco de la República* or through foreign exchange operations.[76]

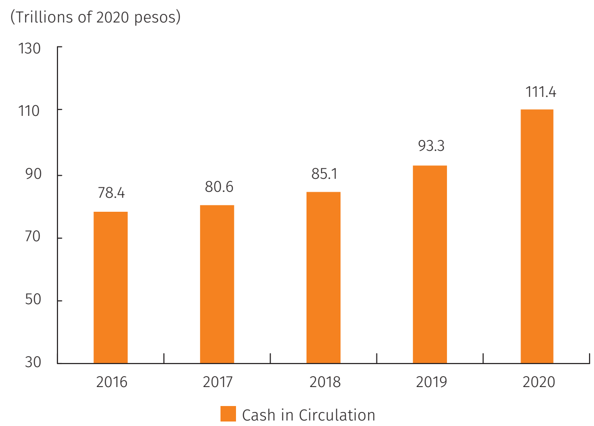
76 The foreign exchange operations consist of *Banco de la República* exchanging new banknotes or banknotes suitable for circulation for deteriorated banknotes in order to improve the quality of the cash in circulation. Foreign currency exchange operations also include the exchange of banknotes for coins.

Graph 5.1
Nominal Value of Cash in Circulation at End of Year (banknotes and coins)



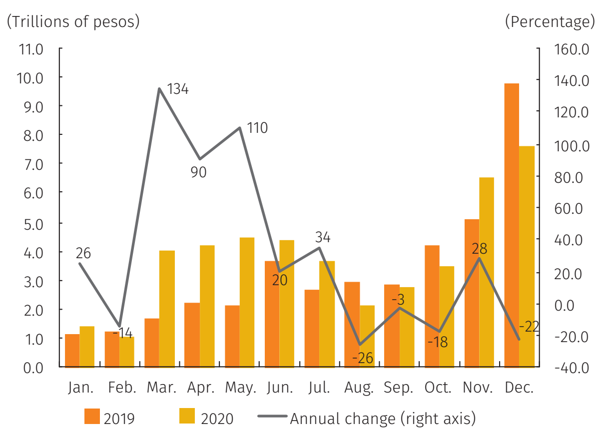
Source: *Banco de la República*

Graph 5.2
Real Value of Cash in Circulation at End of Year (banknotes and coins)



Source: *Banco de la República*

Graph 5.3
Banknote Supply by *Banco de la República*
Monthly Comparison 2019-2020



Source: *Banco de la República*

ii. *Banco de la República*'s public service windows in Bogota and in the thirteen branches that have a treasury office[77] through which they supply mainly low-denomination banknotes and coins through exchange operations

iii. The supplementary cash centers (CCE in Spanish) that operate in twenty-two cities,[78] through which cash is supplied to commercial banks, commerce, public and other economic sectors by means of exchange operations.

The average rates of nominal and real growth of the cash in circulation during the 2016-2019 period stood at 8.3% and 4.0% respectively. In 2020, these rates went to 21.5% and 19.4% due to the pandemic situation. This circulation pattern was mainly influenced by the high demand for cash that started in March 2020 at the beginning of the Covid-19 health emergency. Graphs 5.1 and 5.2 show the changes in the balance of cash in circulation at the end of the year (nominal value and real value respectively) which had a value at the close of 2020 of COP 111.4 billion (b) (98% banknotes and 2.0% coins).

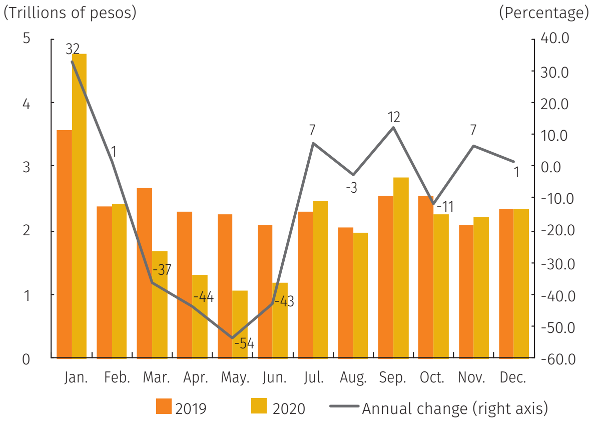
Cash performance in 2020 was the result of high increases in cash withdrawals from commercial banks and a decrease in deposits. The Bank provided the economy with COP 45.9 b in banknotes in 2020, a figure that represented a 15% annual change compared to the value in 2019 (COP 39.8 b). The largest annual changes in the demand for cash in high-value denominations was registered in March, April, and May. This situation arose from the uncertainty associated with the onset of the Covid-19 health emergency (Graph 5.3). This growth contrasted with the reduction in low-value denomination cash transactions for which the value supplied was down 39.3% compared to 2019 against a backdrop of contracting economic activity and lockdown measures. Cash inflows to the Bank, in turn, stood at COP 26.4 b with an annual change of -9% in comparison to the value in 2019 (COP 29 b) along with significant decreases between March and June also associated with the health emergency (Graph 5.4).

***Banco de la República* met the increase in demand for cash by keeping the industrial plants for the production of banknotes and coins in operation and providing services**

77 *Banco de la República* public teller windows are located in Bogota and thirteen branches: Armenia, Barranquilla, Bucaramanga, Cali, Cucuta, Ibague, Leticia, Medellin, Monteria, Pasto, Quibdó, Riohacha and Villavicencio.

78 There are currently 39 CCE operating in twenty-two cities, nine of which are where *Banco de la República* does not provide treasury service (Cartagena, Florencia, Manizales, Neiva, Pereira, Popayán, Santa Marta, Sincelejo, and Valledupar) and thirteen where Banco *de la República* does provide this service (Armenia, Barranquilla, Bogotá, Bucaramanga, Cali, Cúcuta, Ibagué, Medellín, Montería, Pasto, Quibdó, Riohacha, and Villavicencio).

Graph 5.4
Receipt of Banknotes at *Banco de la República*
Monthly Comparison 2019-2020



Source: *Banco de la República*

in its treasury branches throughout the country while complying with the biosecurity measures established by the national government. The Bank reacted to the increased demand for cash generated by the Covid-19 pandemic in timely manner even during March, April, and May when such a high demand for cash is not usually seen. The services of the treasury offices for supplying cash to financial institutions, commerce, and to the general public at teller windows were adjusted to the health emergency situation and provided cash on a non-stop basis. The production of the banknotes most in demand during the pandemic (COP 50,000 and COP 20,000) rose 24% for total bills printed (703.5 million bills) compared to 2019 (567.8 million bills).

The performance of cash in 2020 was similar to what was seen in other countries in different regions because of the ongoing pandemic situation. Graph 5.5 shows real cash growth rates for a sample of countries and the euro area. Growth rates of cash in circulation in some countries became similar to those seen during the 2008 financial crisis and is a situation associated with the role of cash during periods of uncertainty. In the case of Colombia, the financial institutions that requested cash withdrawals the most related the high demand to, mainly, the economic monetary relief adopted by the national government in the context of the health emergency and to the public's holding of cash as a reserve in view of the uncertainty generated by the pandemic. This behavior, as was mentioned above, was confirmed by the low rate of cash returns to banks.

The value of the banknotes in circulation at the end of June 2021 was COP 109.1 b which was similar to what was seen in December 2020 (Graph 5.6). The above is evidence that the demand for cash continues to reflect the impact of the Covid-19 health emergency. Cash provision transactions have stayed at an amount similar to what was seen during the same period in 2020 (Graph 5.7) and were also affected by the problems with public order which has heightened uncertainty since May.

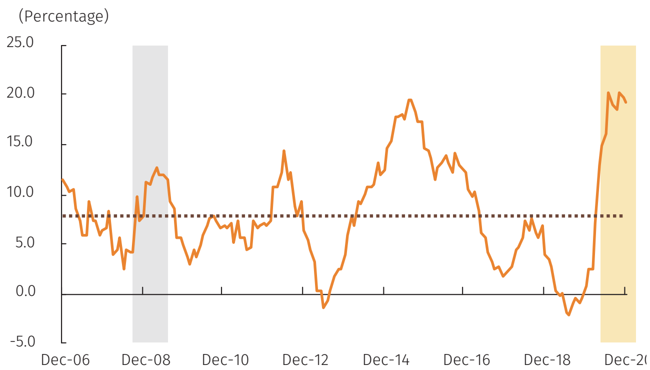
5.2 Payments in the goods and services market

Cash continues to be the most widely used payment instrument by the population for regular payments. Within the market of goods and services, payments are often made for food, beverages, transportation, clothing, utilities, rent or monthly installments to pay for one's own house, etc. When people were asked in 2019 what instrument they preferred for making those regular payments,[79] it was clear that cash

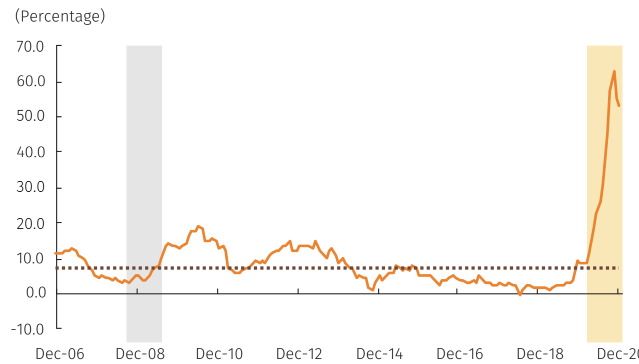
79 Based on the methodological advice of the Office for Economic Studies, the Industrial Office of *Banco de la República* does a national survey on the provision of banknotes and coins and payment instruments (Epbmip) every two years. The main results of the surveys are presented in *Banco de la República*'s Payment Systems Report.

Graph 5.5
Real Annual Growth of Cash in Circulation

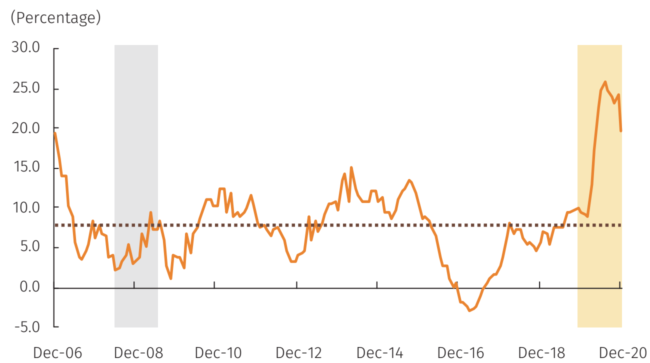
A. Mexico



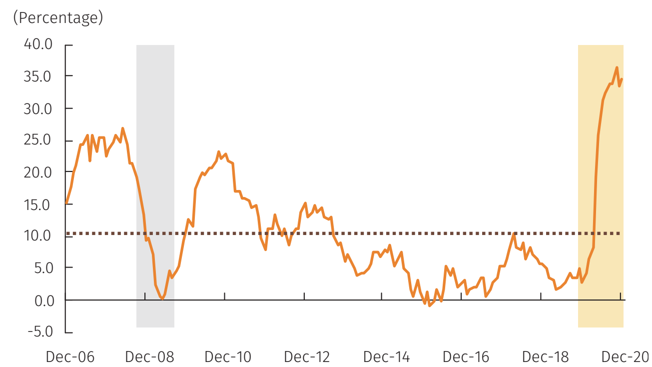
B. Chile



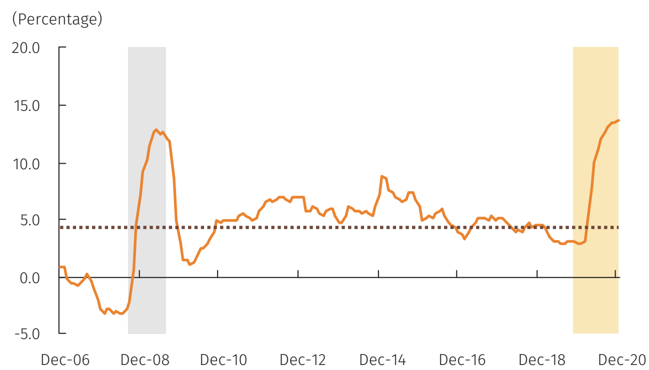
C. Colombia



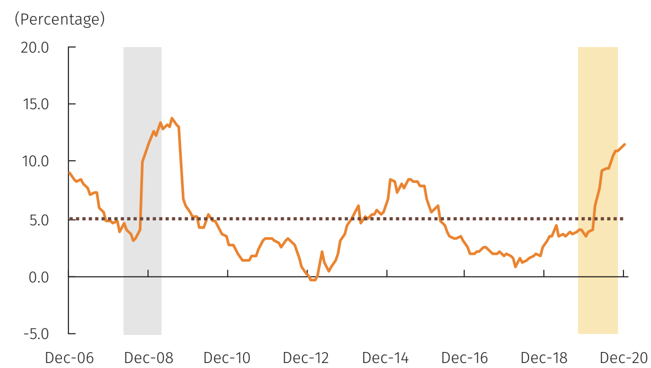
D. Peru



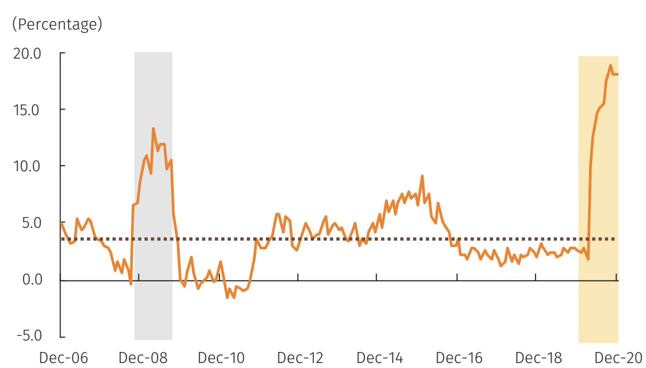
E. United States



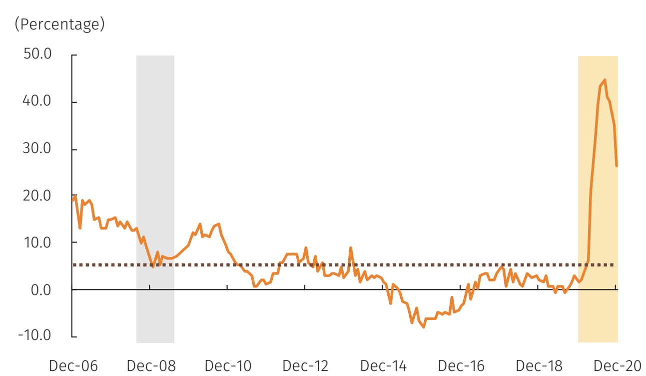
F. Euro zone



G. Australia



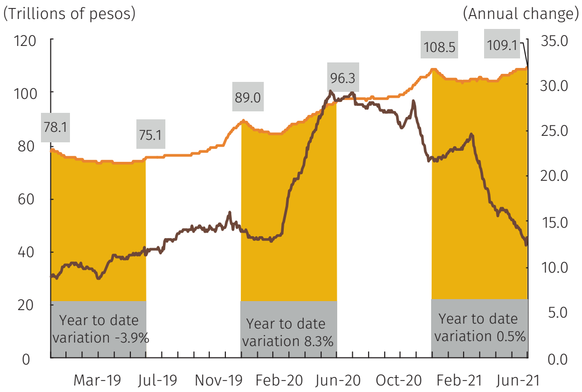
E. Brazil



Average growth rate, 2006-2020 Pandemic Global financial crisis

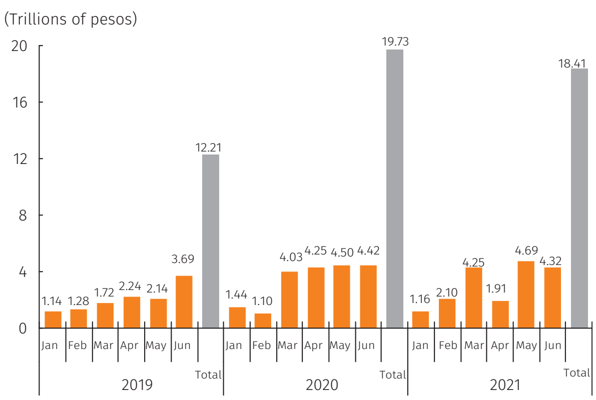
Source: *Banco de la República*

Graph 5.6
Circulation of Banknotes (January 2019 – June 2021)
(annual change)



Source: *Banco de la República*

Graph 5.7
Banknote Supply by *Banco de la República*,
2019– 2021
(January-July, thousands of millions of pesos)



Source: *Banco de la República*

Table 5.1
Electronic Payments, Individuals and Legal Entities

Instrument	2019	2020	Change (percentage)
Credit Card	53.6	44.1	-17.7
Debit Card	52.0	53.5	2.8
Checks	185.6	118,6	-36.1
Transfers	1.028.5	1.116,8	8.6
Total	1.319.6	1.332,9	1.0

Note: electronic payments refers to those that are cleared and settled electronically. Card payments refer to purchases. Payments with checks and transfers correspond to interbank transactions (intrabank payments are not included).
Sources: *Superfinanciera*, ACH Colombia, and *Banco de la República*.

was the favorite by 87%, followed by the debit card (5%), electronic transfer (3%), and credit cards (2%). These results were similar to those obtained in 2017 although there was a slight decrease in the preference for cash – from 90% to 87%. The effect of the pandemic on preferences regarding payment instruments will be assessed once the results of the 2021 survey are obtained.

Electronic payments, both from individuals and firms, remained relatively stable during 2020. The increase in wire transfers offset the decrease in card (credit and debit) and check payments.[80] Electronic transfers and checks are mainly used by legal entities (95% and 86%, respectively) while debit and credit cards are used by individuals (94% and 92%, respectively). Transfers have been the most widely used electronic payment instrument in Colombia in the goods and services market over the last decade, and their use has grown in the last few years. Electronic payments amounted to COP 1.332,9 billion in 2020 (Table 5.1). The 8.6% increase in electronic transfer payments during 2020 offset the 7.6% and 36.1% decrease in payments with cards (credit and debit) and checks, respectively. This substitution of electronic transfers for payments using cards and checks occurred with payments made by individuals and legal entities. In the case of individuals, electronic transfers rose 62.8% while payments with cards and checks declined 6.6% and 51.2% respectively.

5.3 Payments in the financial asset markets

The backbone of Colombia's financial infrastructure is the large-value payment system administered by *Banco de la República*. This system operates on the basis of the deposit accounts (CUD) that financial institutions have with *Banco de la República*. In the large-value payment system, the transactions in the financial assets market are settled in Colombian pesos. The same goes for the retail payment infrastructures where purchases of goods and services are settled. In 2020, the large-value system settled COP 55.5 b on average in daily transactions. In the annual total, the value transacted represented 13.5 times Colombia's GDP in 2020.

During 2020, the amount of the transactions settled in the large-value payment system increased 7.7% compared to 2019. This growth is mainly explained by the increase in the value of interest-bearing deposit transactions carried out by the General Office of Public Credit and the National

80 In this case, *electronic payments* refers to those for which clearing and settlement is done electronically thus, checks are included. Intrabank payments are not included in the reported data; that is, those that are cleared and settled within the financial institutions.

Treasury[81], that went from a COP 4.3 b to a COP 16.4 b daily average as well as by the increase in the amount settled in public debt market transactions that went from a COP 15.8 b to a COP 17.1 b daily average. The latter transactions come from the Central Securities Depository (CSD), which is an infrastructure managed by *Banco de la República* and responsible for clearing and settling transactions in the public debt market. This increase in the settlement of CSD transactions is due to the rise in the value of secured lending (*simultáneas*[82]) involving public debt that rose almost 24% and went from a daily average of COP 5.2 b to one of COP 6.4 b—thus offsetting the decrease in public debt transactions, which went from COP 4.8 b to COP 3.6 b.

The clearing and settlement of transactions by the Central Counterparty Risk Clearinghouse (CCRC) in 2020 was marked by the growth of peso-dollar, non-delivery, forward contracts. The CCRC is a private infrastructure that handles centralized clearing and settlement[83] of forward transactions and standardized and non-standardized derivatives.[84] The value of the transactions cleared and settled by the CCRC during 2020 amounted to a daily average of COP 4.3 b that represented a 12.1% increase compared to the value of the transactions in 2019. The peso-dollar non-delivery forward contracts went from a daily average of COP 2.5 b to one of COP 3.1 b, and this represented a 24% increase. In 2020, the CCRC took in the entire stock market. In 2019, the CCRC cleared and settled financial products grouped into four segments that included financial derivatives, fixed income, interest rate swaps and variable income (i.e., repos on stocks). The CCRC added cash and temporary transfer of stocks to the variable income segment during 2020. As a result of the merger (by common agreement) with the Foreign Exchange Clearinghouse of Colombia (FECC), the foreign currency division was also created in 2020 in order to clear and settle the peso-dollar spot market.

5.4 Regulatory actions and support

Banco de la República **participated in the inter-institutional working groups to define the new regulation of the retail payment system, which was stipulated in Decree 1692/2020.** This decree is based on the fact that the retail payment system is essential for the proper functioning of the financial sector and to increase the efficiency and formality of the economy, thus contributing to the digital transformation of the State and society and facilitating financial inclusion. It covers topics such as definitions relevant to the payment process, the rules applicable to retail payment system administrators (EASPBV in Spanish) who are responsible for clearing and settling transactions as well as the acquiring

81 This rise was mainly the result of the reduction in the weighted average period of these deposits, which went from 41.7 to 11.4 days and thus led to a higher value of transactions processed in the large-value payment system.

82 *Simultáneas* are loans with collateral in which one party (the borrower) receives a security in exchange for the delivery of a sum of money to the lender and undertakes to return the property of said security to the lender at a determined price.

83 As a central counterparty, the Central Counterparty Risk Clearinghouse interposes between buyers and sellers in the market to undertake the centralized clearing and settlement of transactions in order to mitigate counterparty risk.

84 Standardized securities are those whose trading characteristics (value, maturity, type of settlement, etc.) have been previously established by the market administrator (e.g., the stock exchange). In contrast, it is characteristic of trading non-standardized products that agreement is reached directly between the buyer and the seller.

business.[85] Regarding the rules applicable to the EASPBVs, it establishes that only these entities may carry out the clearing and settlement of retail payment systems. This is an important change, as it requires the acquiring business to be split from the clearing and settlement business. Regarding the acquiring business, it stipulates that it may be done not only by credit institutions, but also by companies that specialize in electronic deposits and payments (Sedpe), and by companies not supervised by the Financial Superintendency of Colombia. All of this is intended to modernize the rules of the retail payment system in order to enhance access, transparency, integrity, stability, efficiency, innovation, and interoperability as well as to protect the interests of payment service users.

As the foreign exchange authority, the Board of Directors of *Banco de la República* issued the corresponding regulation in view of the merger (by common agreement) of the Foreign Exchange Clearinghouse of Colombia[86] and the Central Counterparty Risk Clearinghouse (CCRC) in 2020. The purpose for this merger, of which the CRCC is the absorbing entity, was to provide greater liquidity to the foreign exchange market. This was achieved by mitigating counterparty risk through the interposition of the CCRC as the counterparty to all obligations in the clearing and settlement of foreign exchange transactions. As a consequence of the merger, the Board of Directors of *Banco de la República* adjusted the corresponding regulation for the proper clearing and settlement of currency spot transactions. Thus, the Central Counterparty Risk Clearinghouse was authorized to carry out the clearing and settlement of peso-dollar spot purchase and sale contracts as counterparty. It also included cash in U.S. dollars as an eligible asset for providing guarantees.

85 This consists of the implementation and completion of the following responsibilities: 1) linking businesses to the retail payment system; 2) providing businesses with access technologies that enable them to use payment instruments; 3) processing and handling payment or fund transfer orders that were initiated through access technologies, and 4) to pay the proceeds from sales made through the access technologies provided.

86 The function of the Colombian Foreign Exchange Clearinghouse was to clear and settle foreign exchange spot transactions between intermediaries in the foreign exchange market.

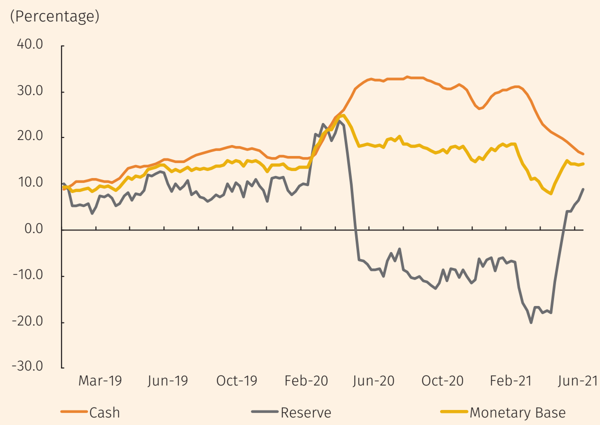
Shaded section 1: Monetary Base and M3

During the first half of 2021, the monetary aggregates showed lower growth than in the previous months, largely due to the effect on the annual variation of the abrupt changes in level registered in March and in the second quarter of 2020. They also continued to reflect a preference for liquid assets.

In the case of the monetary base, the average annual growth was 14.1% for the first half of 2021 (vs. 18.0% for all of 2020) as a result of an annual change of 24.5% for cash held by the public and -7.1% for the banking reserve (vs. 27.2% and 0.0% in 2020). Regarding cash, the main component of the monetary base, annual increases went from around 30% in late 2020 and early 2021 to about 17% in June, partly because the base effect from the change in its level in the second quarter of 2020 was gradually diluted.[1] Although these growth rates are lower than those registered in 2020, they are still high compared to their historical averages.[2] In contrast, the banking reserve went from showing declines at the end of 2020 and early 2021 to positive changes in annual terms due to the fact that May marked one full year since the decrease in reserve requirement ratios began to be applied and, therefore, the drop in the required reserve level[3] (Graph S1.1).

At the end of June and, in comparison to the end of December 2020, there was a COP 3.296 billion (b) drop in the monetary base caused by a COP 5.284 b decrease in the banking reserve and a COP 1.988 b increase in cash held by the public. By sources, most of the time temporary liquidity operations (repos and monetary contraction deposits (DRNCE by its acronym in Spanish) offset the movements of the government deposits at the Bank to the extent that they exceeded the change in the monetary base

Graph S1.1
Monetary Base, Cash, and Reserves (annual percentage change, 4-week moving average)



Source: *Banco de la República*, calculations based on information from the Office of the Financial Superintendent of Colombia.

demand. The exception was March[4] and April when the Bank sold COP 5.921 b in TES on the secondary market to partially offset the sharp increase in the monetary base supply generated the maturing of TES in March (close to COP 10.800 b[5]). Furthermore, principal and interest on the private debt portfolio held by the Bank matured, and this caused a COP 2.356 b contraction of the monetary base (Graph S1.2).

The M3 and deposits held by the public in the first half of 2021,[6] in turn, registered an average annual change of 8.9% and 6.5% respectively (vs. 13.6% and 11.7% throughout 2020). Annual growth in the second quarter was lower than in the first quarter and low in historical terms[7] due to the high base of

1 In 2020, there was a significant rise in the level of cash between March and June.

2 Using the total CPI as a deflator, the real average annual growth of cash during the first half of the year was 21.8% (27.7% in the first quarter and 15.9% in the second) compared to an average of 7.4% since 1984.

3 The decline in the reserve requirements established by the BDBR on 14 April 2020 applied as of the two-week period beginning 13 May 2020. See https://www.banrep.gov.co/es/banco-republica-inyecta-liquidez-permanente-economia-mediante-reduccion-del-encaje-y-refuerza-su

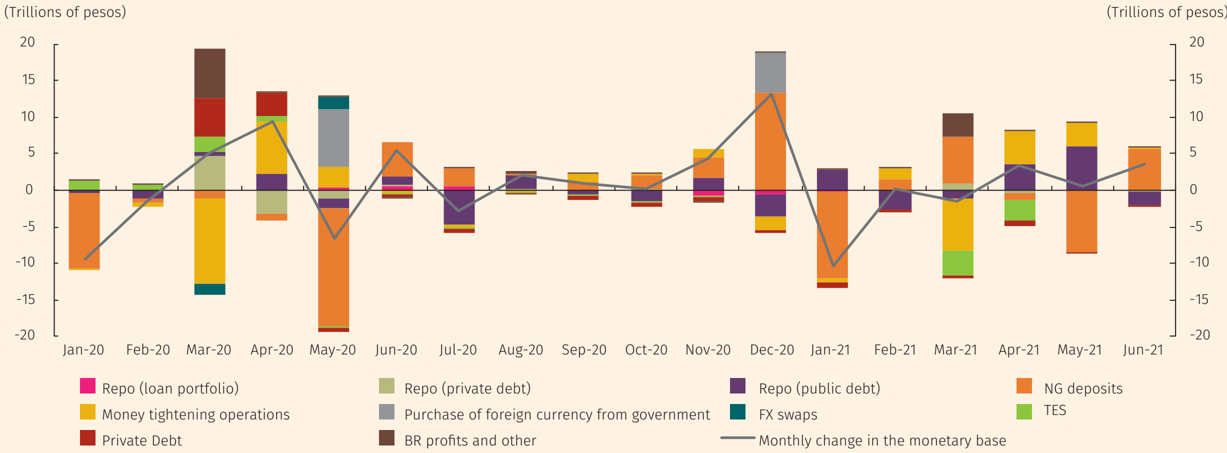
4 The Bank also paid COP 6.629b in profits corresponding to 2020 to the national government in March. Of these, at the request of the Ministry of the Treasury the BDBR paid COP 3.506,2 b in TES and the remaining amount was deposited in the government's account at *Banco de la República*.

5 Short-term TES with a nominal value of COP 2.850 b matured on 09 March 2021 and UVR TES with a nominal value of COP 7.923 b matured on 10 March 2021 (see https://www.irc.gov.co).

6 Does not include the CDs nor bonds held by *Banco de la República*.

7 Using the total CPI as a deflator, the average annual growth in the second quarter was 3.1% for M3 and 1.2% for deposits. These are the lowest since the first quarter of 2018 and 2003.

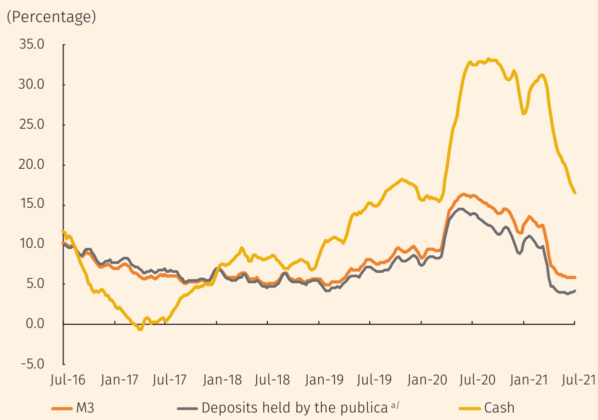
Graph S1.2
Change in the Monetary Base by Sources



Note: Positive values imply an expansion of the monetary base and negative ones imply a contraction.
Source: *Banco de la República*

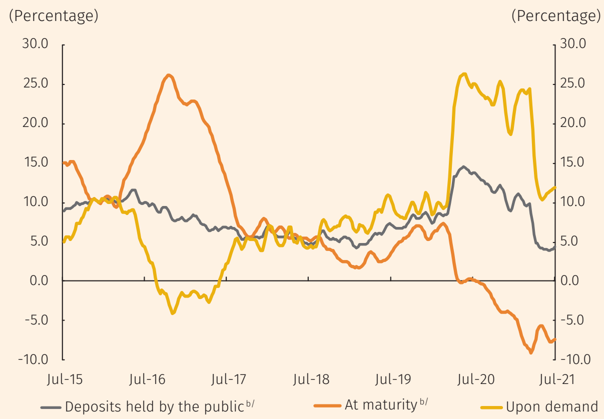
comparison in 2020[8] (Graph S1.3). Regarding deposits held by the public, it was evident that a preference for demand deposits persists. At the end of June, demand deposits showed annual increases similar to those registered during the first few months of 2020 (before the pandemic) despite of the high base for comparison. On the contrary, the balance for term deposits continued to decrease (-7.2% per year on average), especially those with a maturity of more than one year (Graph S1.4).

Graph S1.3
M3 and its components
(annual percentage change, 4-week moving average)



a/ Excludes CDs and bonds held by *Banco de la República*.
Source: *Banco de la República*, calculations based on format 281 from Financial Superintendency of Colombia.

Graph S1.4
Deposits Held by the Public[a/] and their Components
(annual percentage change, 4-week moving average)



a/ Excludes CDs and bonds held by *Banco de la República*.
b/ Based on the statistics as of 28 August 2020, the bonds and CDs held by *Banco de la República* were excluded, and the series was reprocessed starting 27 March 2020 to date.
Source: *Banco de la República*, calculations based on format 281 from Financial Superintendency of Colombia.

8 For deposits held by the public and, therefore, for M3, the increase in level occurred mostly in March and in the first weeks of April in 2020.

Shaded section 2: **Colombia's Foreign Balance in the First Quarter of 2021**

The country's current balance of payments deficit which was estimated at USD 3,633 million (m) for the first quarter of 2021 was USD 1,092 m higher than it was a year ago (Table S2.1). As a share of the quarterly GDP, the deficit was estimated to be 4.8% which is 1.3 percentage points (pp) higher than the estimate for the previous year.

Although still subject to the changing domestic and international economic and financial conditions brought about by the Covid-19 pandemic, the first quarter of 2021 was characterized by the recovery of domestic demand. This was reflected in the expansion of the current deficit that was partially offset by the improvement in the prices of our main export goods. First of all, growth in both household spending and gross fixed capital formation that saw annual changes of 2.9% and 5.3% respectively are reflected in the increase in both imported goods and services and sales by companies with foreign direct investment (FDI). The latter is seen in the increase in net factor income outflows (USD 474 m). Moreover, despite the better prices and the recovery of our main trading partners, the smaller amounts shipped accounts for the decline in exports of goods. Consequently, in view of the higher value of imports compared to the decrease in the number of exports, the trade balance deficit expanded USD 568 m compared to a year ago (Table S2.1). To a lesser extent, the deficit in the balance of services also rose (USD 382 m). The net income from current transfers, in turn, rose USD 332 m.

Although the change in Colombia's current account balance of payments shows a close relationship with the performance of the trade balance in goods due to the high share of exports and imports in the country's total current income and expenditures,[1] factor income has become a significant source of the country's current account deficit during the period under analysis.

The counterpart to the country's higher current deficit was the higher need for financing since, in the first quarter of 2021, the financial account[2] registered net capital inflows of USD 3.162 m (4.2% of the GDP) that were higher than what had been seen a year ago when they totaled USD 2.166 m (3.0% of the GDP) (Table S2.1).

The sources of financing the current deficit abroad were as follows: FDI (USD 2,703 m; 3.6% of the GDP) which was USD 737 m lower compared to the same period in 2020 and partially offset by USD 1.168 m in net repayment on other foreign loans and USD 896 m in foreign portfolio investment liquidations.

The results described above imply that the structure of the external financing sources for the current deficit will once again reflect the breakdown in recent years when FDI capital was the main foreign financing source as opposed to what happened in 2020 when public foreign debt became the main source of foreign financing. Note that, notwithstanding the above, capital flows from FDI decreased as a result of lower incoming funds as both capital inflows and inter-affiliate lending declined during the first quarter of 2021. This was evident in the majority of economic activities, especially in the electricity, gas and water supply, manufacturing, and oil, mining, and quarrying sectors.

The performance of the different components of the balance of payments is described in greater detail (Table S2.1) below.

Foreign trade in goods during the first quarter of 2021 registered a deficit balance of USD 2,668 m which is USD 568 m higher than the one a year ago. This growth in the deficit was caused by the increase in imports (USD 504 m, 4.4%) and the decrease in the value of exports (USD 64 m, 0.7%) (Table S2.1).

1 The analysis of the structure and the change in the current account income over the last 15 years shows that sales abroad of merchandise are its main component and hold a share that ranges between 63% and 81% of the total income. Regarding the current expenditures, their most important component is imported goods which represented, on average, 64% of the total outlays (65.4% during the first quarter of 2021).

2 According to the IMF's proposed Balance of Payments Manual (sixth version), the financial account has the same sign as the current account. The financial account is the result of the difference between asset and liability flows. If the current account has a deficit, then the financial account is negative, and this indicates that the Colombian economy has had to resort to external financing (liabilities) and/or liquidate its foreign assets in order to finance its current excess spending. In contrast, if the current account is positive (surplus), the financial account will also be positive which would indicate that the country has the capacity to lend funds to the rest of the world.

Table S2.1
Colombia's Balance of Payments

Current Account (millions of dollars)	2020 (p) Jan-Mar	2021 (p) Jan-Mar	Change (dollars)
Current Account (A + B + C)	-2,541	-3,633	-1,092
Percentage of the GDP	-3,5%	-4,8%	
A. Goods and Services	-2,992	-3,942	-950
1. Goods	-2,100	-2,668	-568
Exports FOB	9,287	9,223	-64
Imports FOB	11,387	11,891	504
2. Services	-892	-1,274	-382
Exports	2,473	1,449	-1,024
Imports	3,364	2,722	-642
B. Factor Income	-1,687	-2,161	-474
Income	1,148	1,148	-0
Outlays	2,835	3,309	474
C. Current Transfers	2,138	2,469	332
Income	2,364	2,721	357
Outlays	226	252	26
Financial Account Annual flows (millions of dollars)	**2020 (p) Jan-Mar**	**2021 (p) Jan-Mar**	**Change (dollars)**
Financial account with change in foreign reserves (A + B + C + D)	-2,166	-3,162	-996
Percentage of the GDP	-3.0%	-4.2%	
A. Direct Investment (ii-i)	-2,201	-1,874	327
i. Foreign in Colombia (FDI)	3,440	2,703	
Percentage of the GDP (FDI)	4.7%	3.6%	
ii. Colombian abroad	1,238	829	
B. Portfolio Investment (1+2)	-265	742	1,007
1. Public Sector (ii-i)	-588	-318	
i. Foreign Portfolio Investment (a+b)	-289	-416	
a. International markets (bonds)	532	281	
b. Local Market (TES)	-822	-697	
ii. Portfolio Investment Abroad	-878	-734	
2. Private Sector (ii - i)	323	1,060	
i. Foreign Portfolio Investment (a+b)	-413	-480	
a. International markets (bonds)	-250	-212	
b. Local markets	-163	-269	
ii. Portfolio Investment Abroad	-90	579	
C. Other Capital Flows public sector + private sector	472	-2,220	-2,692
D. Reserve Assets	-171	190	361
Errors and Omissions (E and O)	375	471	96
Memo item:			
Financial account excluding change in foreign reserves	-1,995	-3,353	-1,358
Change in Foreign Reserves	-171	190	

(p): provisional
(pr): preliminary
Source: *Banco de la República*

The decline in exports was mainly the result of lower sales of coal (USD 649 m) and, to a lesser degree, the reduction in sales of petroleum and its derivatives (USD 54 m), and of bananas (USD 41 m). In contrast, the sales abroad of industrial products (USD 404 m), non-monetary gold (USD 251 m), coffee (USD 160 m), and flowers (USD 55 m) rose. The lower export value of crude oil and coal is due to the lower volume exported (25.8% and 46.1% respectively). This was partially offset by the increase in their export prices (35.3% and 10.6% respectively). As regards exports of non-monetary gold and coffee, the increase was due to the rise in both the quantities shipped (37.7% and 9.1% respectively) and the sales prices (17.9% and 15.6% respectively).

The increase in the value of imports was mainly the result of the rise in imports of supplies and capital goods for industry (USD 667 m; 11.3%), and in consumer goods (USD 175 m; 6.3%) and was partially offset by the decline in purchases abroad of fuel and lubricants (USD 202 m; 25.1%).

Regarding the country's terms of trade, these rose 12.9% during the first quarter of 2021 with respect to the same period in 2020 spurred by the increase in crude oil prices. The growth in the terms of trade is explained by the higher increase in export prices (16.2%), compared to those of imports (2.8%).

The deficit in the service account, in turn, rose USD 382 m during the first quarter of 2021 (Table S2.1) due to the greater reduction of service exports compared to declines in imported services. The decline in the country's foreign trade in services has taken place in the context of the Covid-19 pandemic, which forced countries to close their economies and international borders to reduce contagion and mitigate the effects on public health. In this context, travel and transportation services have lost relevance in the values exported and imported by Colombia. One year ago, these categories accounted for 70% and 50% of the total value of exports and imports of services while in the first quarter of 2021, they fell to 49% and 44% respectively.

The sharp reduction in the export of services was driven by lower sales of traditional services,[3] USD 1,011 m (59%) while modern services[4] had an annual growth of USD 16 m (2.5%) spurred by call center services that offset the declines in other services[5] in this category. Services such as contact centers have been driven by the way the quarantines around the world pushed everything online since non-face-to-face services through the use of information and communication technologies have been required.

The lowest imports, in turn, occurred in the three groups of services. Traditional imports fell USD 502 m (30%), a trend driven by the fall in travel services (USD 588 m), which was not offset by the growth in imports of transportation services (USD 86 m). Modern services decreased USD 110 m (12%) with purchases of business services declining the most. Finally, other services decreased USD 30 m (4%) due to the lower imports of financial services and maintenance and repair services.

During the period under analysis, a deficit balance of factor income (primary income) is estimated at USD 2,161 m. This was USD 474 m higher compared to a year ago (Table S2.1) and mainly due to the higher outflows from FDI-related profits (USD 428 m). There was an overall increase in FDI profits with the estimated increase in profits for companies operating in oil drilling (USD 183 m), manufacturing industries (USD 90 m) supplying electricity, gas, and water (USD 76 m), and trade, restaurants, and hotels (USD 41 m).

Regarding current transfers, in the first quarter of 2021 USD 2,469 m of net income were received, an amount that was 15.5% (USD 332 m) more than what had been received a year before. This result is explained mainly of the amount in remittances from workers that amounted to USD 1,937 m with an annual increase of 10.2% (USD 179 m).This increase came from the remittances sent from the United States and Spain that grew 14% and 30% per annum while those from countries in Latin America declined 6.0%.

As for the result of the financial account, in the first quarter of 2021, USD 3,162 m in net capital inflows were registered, which was USD 996 m higher than what had been seen a year earlier. These net inflows were due to foreign capital income (USD 638 m), income from the liquidation of Colombian capital abroad (USD 2,376 m), payments of non-residents to residents due to financial derivatives (USD 339 m) and increases in the foreign reserves as a result of balance of payment transactions (USD 190 m). The errors and omissions were estimated at USD 471 m (Table S2.1).

3 Travel and transportation are classified as traditional services.

4 This group includes telecommunications, computer and information services, charges for the use of intellectual property, and other business services.

5 Other services include financial services, insurance and pension services, manufacturing of physical supplies belonging to others, maintenance and repair services, personal, cultural and recreational services, and government services.

These inflows were the result of USD 2.703 tm in FDI that were partially offset by USD 1,168 m in net repayment on loans and in other credit abroad and liquidations of USD 896 m in foreign portfolio investments.

In the first quarter of 2021, USD 2,703 was received through FDI (3.6% of the quarterly GDP), an amount that was USD 737 m (21.4%) lower than what had been received a year earlier. The distribution of FDI received during this period by economic activity was as follows: mining and petroleum (34%), transportation and communications (22%), financial and business services (19%), electricity (7%), commerce and hotels (6%), manufacturing industry (1%), and the rest of the sectors (11%). The flow of Colombian direct investment abroad, in turn, was estimated at USD 829 m and the majority of this was by businesses in the mining and financial sectors.

Between January and March 2021, foreign portfolio divestments, in turn, were estimated at USD 896 m (1.2% of the quarterly GDP). This was the result of the net sales of fixed income (USD 697 m) and variable income (USD 269 m) securities on the local market by non-residents and payments on principal made by the private sector on debt securities issued in the international markets (USD 212 m). This was partially offset by net income received from the placement of long-term debt securities in international markets by the national government and public sector companies USD 281 m).

Outflows of Colombian capital for this totaled USD 155 m in net liquidations and corresponded to settlements made by the public sector (USD 734 m) that were partly offset by portfolio investments made in the private sector (USD 579 m) (Table S2.1).

Finally, due to other capital flows, the country received USD 2,220 m in net inflows. This is partly explained by USD 1.168 m in net repayments on loans and other credit that was mainly long-term. Of these, the private sector made net repayments of USD 1,494 m. USD 858 m of this was for long-term loans and USD 719 m for short-term debt. The public sector, in turn, received USD 325 m in net disbursements, mainly from long-term loans contracted with international organizations. The reduction in other financial assets (USD 3,050), in turn, is mainly attributable to the USD 2,818 m decrease in the balance of public sector deposits abroad.

Shaded section 3: **The Department Economies in 2020**

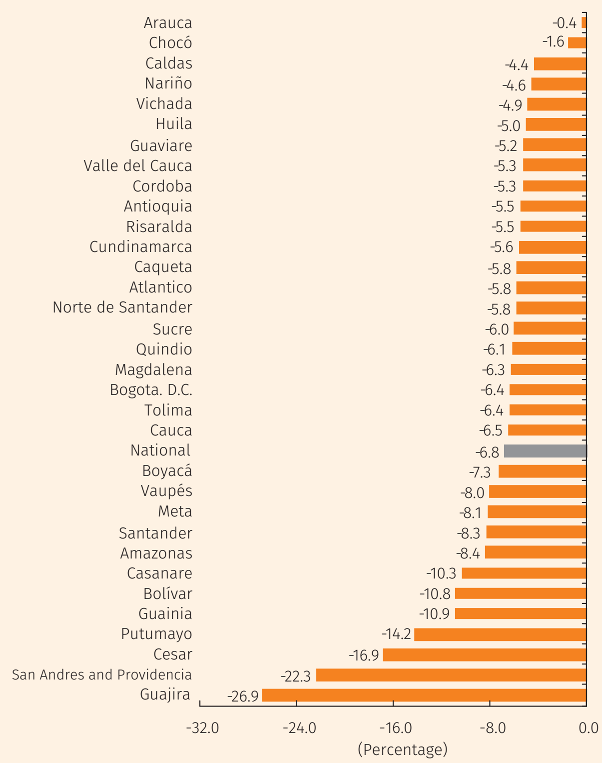
In Colombia, a country characterized by a geographic structure based on departments whose economies define national trends, it is important to inquire into the specific performance in the territories. This is possible because of the departmental GDP figures produced annually by DANE.

Based on the most recent departmental GDP figures for 2020, published by DANE,[1] the country's 33 territories showed the effect of the Covid-19 pandemic and the social isolation measures implemented to prevent its expansion by registering a generalized annual drop in their economies.

The most negative impacts were seen in the departments mainly concentrated in two regions: Caribe (La Guajira, San Andres and Providencia, Cesar, and Bolívar) and Suroriente (Putumayo, Guainía, Casanare, Amazonas, Meta, and Vaupes). In addition to these, Santander and Boyacá also showed a greater reduction than the national total (6.8%) (Graph S3.1). San Andres, and Providencia, where the second largest decline was registered (22.3%), saw their main trade activities severely affected by the cancellation of flights and cruise ships not only because of the effects of the pandemic but also to the devastating impact of hurricane Iota at the end of the year.

Those departments where a significant part of the economy is based on the mining sector associated the negative trend with the drop in the international prices for crude oil and coal as well as the decline in demand due to the temporary paralysis of the world's economies caused by the Covid-19 pandemic. The decrease in crude oil production contributed to the deterioration in Meta, Casanare, and Santander while, with respect to coal, the departments that were affected the most were Cesar and La Guajira which are two of the three territories with the largest GDP decline with annual changes of -26.9% and -16.9% respectively (Map S3.1). In contrast, with gold mining in a high-price environment, economies such as Antioquia, Caldas, and Choco benefited with the latter being the department with the second smallest annual decline in 2020.

Graph S3.1
Annual Change of Departmental GDP, 2020



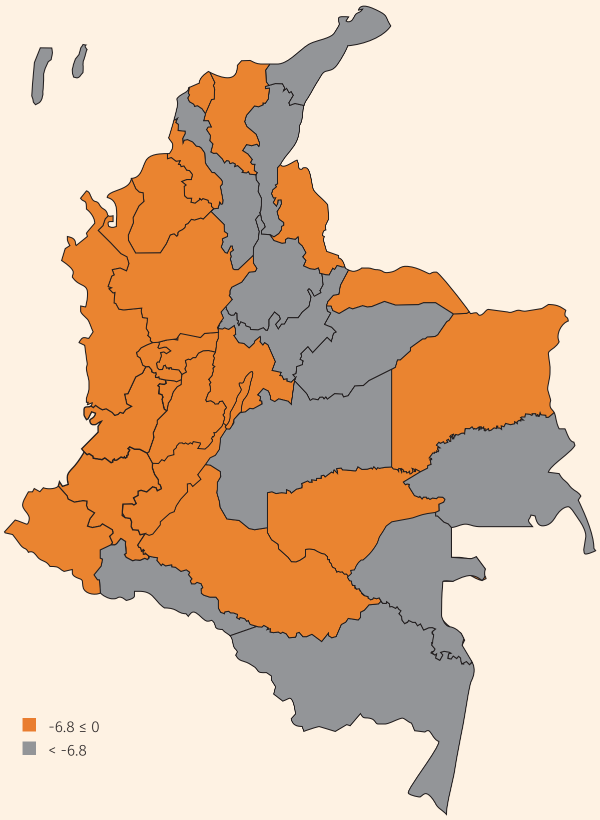
Note: preliminary figures.
Source: DANE, calculations by *Banco de la República*.

The figures, in turn, revealed that the seven territories with the largest share accounted for 71.2% of national GDP. Of these, Bogota accounted for more than a quarter of the total (26%) and given its contraction, made the largest contribution to the country's negative result (1.6 pp). It was followed by Antioquia, Valle del Cauca, Santander, Cundinamarca, Atlántico, and Bolivar, whose contributions were between 0.8 pp and 0.3 pp.

Note that in these territories the sectors most affected by the pandemic in 2020 were construction, commerce, and industry. In construction, which had already showed a downturn starting in 2019 in Bogota and Valle del Cauca, the declines fluctuated between 28.7% and 26.2%. As for trade, declines ranged from 30.2% to 10.5% with the highest percentage for

1 DANE published the 2020 departmental GDP on 25 June 2021 for 33 territories in Colombia (preliminary figures).

Map S3.1
Annual Growth of the Real Departmental GDP, 2020



Note: preliminary figures.
Source: DANE, calculations by *Banco de la República*.

Bolivar. And in manufacturing, the downturn ranged between 12.1% and 3.7% with Bogota experiencing the greatest deterioration while Valle del Cauca was the least affected. Even though industry declined in general terms, some subsectors showed better performance. For example, food and beverages and chemical products related to cleaning and biosafety were in continuous use throughout the year compared to other subsectors that were subjected to greater restrictions for reopening.

In contrast to the above, one of the sectors that offset the economic downturn to a large extent in the majority of the departments around the country was agricultural where growth was associated with normal food supply in the midst of the health emergency. Valle del Cauca, Antioquia and Cundinamarca stood out for their greater share of the sector since, in aggregate, they accounted for 35% of the activity. Other sectors that also cushioned the generalized fall in the different territories around the country were: real estate; public administration, education and health; and finance and insurance.

Thus, all of the departments experienced setbacks in their economies in 2020 after the sudden interruption in most areas of work because of the declaration of a health emergency resulting from the Covid-19 pandemic and the mandatory isolation measures implemented to limit its spread. As economic activities gradually opened up, there was a gradual reactivation of the country's departmental economies. Nevertheless, at the end of the year, the new measures to contain the second wave of infections slowed down the pace of recovery in the major capital cities where the concentration of people is the highest.

Shaded section 4: **Participation of *Banco de la República* at the Bank for International Settlements (BIS)**

In compliance with Act 1484 of 12 December 2011, which authorized *Banco de la República's* incorporation as a shareholder of the Bank for International Settlements (BIS),[1] this shaded section presents a report on the activities carried out with that entity during the last year. Based on the authorization conferred on it, the Bank acquired 3,000 shares of the BIS for a price of 65,712,000 in special drawing rights (SDR), which is equivalent to USD 100,978,710 that are registered on the financial statements of the Bank at their acquisition cost in SDR under "contributions to international organizations and entities."

This year, as stipulated by the BIS Board of Governors in 2021, the decision was made to pay a supplementary dividend to compensate for the absence of a dividend in the 2019-2020 period. Thus, the profits for the 2020-2021 period also went to the General Reserve Fund, the Free Reserve Fund, and the Special Dividend Reserve Fund of the BIS. The channeling of resources to the latter fund is intended to help mitigate the impact on the dividends of more variable earnings and facilitate a more stable dividend for shareholders in the future.

In recent months, the directors of *Banco de la República* have, as usual, participated in the periodic meetings that the organization holds in which recent events and the outlook for the global economy and financial markets are examined. Recent discussions at the meetings of BIS member country governors have focused on a variety of topics such as the effects of the Covid-19 pandemic on the global economy, the current global financial conditions, the interaction between monetary and fiscal policy, the risks that central banks have faced after a year of pandemic lockdowns, macro-financial stability frameworks, the effects of an uneven economic recovery, and how central banks can address the risks from climate change.

Likewise, within the BIS consultative groups that coordinate research and analysis in areas such as financial stability and banking operations, the institution created the Consultative Group on Risk Management (CGRM) in March of this year. The goal of this group is to establish a forum for sharing experiences and technical expertise on the monitoring, assessment, and mitigation of various forms of risk among BIS member central banks in the region. The CGRM held its inaugural meeting at the end of May, where they decided that the topics to be worked on will be related to cybersecurity issues, ESG criteria,[2] and risk management governance, etc. *Banco de la República* participates in this consultative group.

The participation of the Bank's senior management in the virtual conferences and seminars organized around the 20th BIS Annual Conference that was held at the end of June this year was also noteworthy. The focus of this year's discussions was on the sovereign bond market and central banks, fiscal policy and public debt, women in central banks, inequality and monetary policy, and the role of central banks in the era of digital decentralization. The events were streamed live to the general public on the BIS website.[3]

In addition, in the BIS 91st Annual General Meeting, the organization presented the Annual Economic Report 2021.[4] The report is divided into three chapters that focus on developments in the economic situation which resulted from the health crisis, the distributional footprint of monetary policy, and the recent developments in central bank digital currencies (CBDC). Some of the Bank's officials attended these presentations online.

1 This international institution was created in 1930 and currently includes 62 central banks. Its mission is to serve the central bank in their quest for monetary and financial stability by fostering international cooperation in these areas as well as to serve as bank for member central banks. Its headquarters are located in Basel, Switzerland, and it has two representative offices: one in Hong Kong and another in Mexico City.

2 Environmental, social and corporate governance (ESG) criteria.

3 The events broadcast by the BIS during the 20th Annual Conference are available at: https://www.bis.org/events/conf210623/overview.htm

4 The report is available at the following link: https://www.bis.org/publ/arpdf/ar2021e.htm

Representatives of the Bank also had the opportunity to attend the virtual conference on macro-financial stability policy organized by the BIS and the Monetary Authority of Singapore as part of the special edition of the Asian Monetary Policy Forum organized this year. The event, which was held at the end of May, brought together central bank governors, senior officials, and scholars to discuss macroprudential policies.[5]

Lastly, the new BIS Innovation Hub Centres located in London and Stockholm were inaugurated in June 2021. These new centers complement those already established in Hong Kong, Singapore and Switzerland. In the coming months, the BIS will open other centers in Toronto, Frankfurt, and Paris. They will also establish a strategic partnership with the Federal Reserve System. The opening of these centers will expand the reach of the BIS in order to build a global network to enhance innovation in financial technology. In early June, the BIS also held a conference online on practices that the financial sector should adopt against climate change-related risks.[6] This conference was organized jointly with the Bank of France, the International Monetary Fund, and the Network for Greening the Financial System.

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5 The agenda and the recording of the event are available at the following link: https://www.bis.org/events/ampf_2021.htm

6 Recordings and materials from the conference are available at the following link: https://www.bis.org/events/green_swan_2021/overview.htm

Box 1
Quarterly National Accounts by Institutional Sector

As of 30 June 2021, *Banco de la República*, together with DANE, began to publish quarterly national accounts by institutional sector (CNTSI in Spanish). This work is the result of a joint effort to generate statistics that meet international quality standards and represents a major advance in the production of macroeconomic statistics in Colombia.[1]

This example of inter-institutional collaboration is particularly noteworthy and received both financial support from the Secretariat for Economic Affairs of the Ministry of Foreign Affairs (SECO) of the Swiss government and technical support from the International Monetary Fund (IMF).

This is an ongoing, long-term effort that began nearly five years ago as part of Colombia's commitment to join the Organization for Economic Cooperation and Development (OECD).

1. What does the CNSI consist of?

Countries use the statistical framework provided by the System of National Accounts (SNA) to produce the CNSI (SCN, 2008).[2] As can be seen in Diagram B1.1, the CNSI presents the measurement of a country's economic activity in two large blocks. The orange blocks show the income and expenditure (final consumption and capital formation [CF] or investment) of the total economy or of each of the sectors into which the economy is divided.[3] The yellow blocks present acquisitions and disposals of financial assets and liabilities. The orange block is commonly known as the real net loan or "above the line" and is prepared by DANE. The yellow block corresponds to the calculation of the net financial loan or "below the line" generated by *Banco de la República*.

Diagram B1.1 shows the savings and investment imbalances horizontally by institutional sector. When all of the institutional sectors are compiled vertically, the conclusion can be drawn that the imbalance of savings and investment (S - I) of the total economy corresponds to the balance in the current account and in the financial account of the balance of payments.

In terms of quantity, these two measurements should show similar results. However, there are methodological and coverage differences that produce aggregate and sector discrepancies in the calculation process that must be reconciled between the two institutions in order to explain and minimize such discrepancies.

2. Why does the release of the quarterly CNSI represent a breakthrough in the production of macroeconomic statistics in Colombia?

Up to now, *Banco de la República* and DANE have only prepared and disseminated annual statistics on the CNSI with significant lags of ten and thirteen months respectively. In addition, the figures were reported separately, and a reconciliation was only done for the general government sector.

The CNSIs have become available on a quarterly basis with a ninety-day lag since June 30, 2021, to provide users with more opportunity and more information as it becomes available; and, under a quarterly review policy, the statistics will be more accurate.

The dissemination of the CNSI is carried out by the two entities jointly, comprehensively, and in coordination. This process means that the teams from the two institutions will technically reconcile the net lending results in order to reduce the statistical discrepancy and explain the reasons for the differences that persist.

The coordinated work of the two entities guarantees the macroeconomic coherence and consistency of the results, which, in turn, constitute a very important tool for the analysis and monitoring of the Colombian economy.

3. Results of consolidated accounts with net financial and non-financial borrowing in 2020

In 2020, net non-financial borrowing, calculated by DANE, points to an imbalance of -4.6% of the GDP, down 0.9 percentage points (pp) from 2019. By economic sector, the imbalance is mainly the result of the net borrowing by the general government that came to -8.7% of the GDP and was partially offset by households' and financial corporations' surpluses of 4.5% and 0.7% of the GDP respectively (Tables B1.1 and B1.2).

In the case of the general government, the deficit came to COP 87.5 billion (b) (8.7% of the GDP) which was COP 44.2 b (4.6 pp of the GDP) higher than in 2019. This rise was mostly caused by the COP 41.1 b decrease in their disposable

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1 More project information and methodological documents are available at the following links:

https://www.banrep.gov.co/es/estadisticas/flujos-cuentas-financieras-scn-2008

https://www.dane.gov.co/index.php/estadisticas-por-tema/cuentas-nacionales/cuentas-nacionales-trimestrales-por-sector-institucional-cntsi

2 All other IMF statistical manuals converge with and are standardized to it including, for example: 1) the quarterly national accounts (2017); 2) monetary and financial statistics; 3) foreign debt statistics; 4) balance of payments and international financial position; 5) public finance statistics, and 6) public sector debt statistics.

3 The economy is divided into six sectors as follows: 1) general government, 2) investment banks, 3) non-financial corporations, 4) households, 5) not-for-profit institutions that serve households and 6) the rest of the world.

Diagram B1.1
National Accounts by Institutional Sector

Savings minus Investment (S - I)	=	Net Real DANE Loan	=	Net Financial BR Loan
	=	Savings - Capital formation	=	Capital account of the Balance of Payments
	=	Available income - Final consumption - Capital formation	=	

Savings minus Investment (S - I)	=	GDP		Salaries	+	Other net income a/	-	Final consumption	-	Capital formation	=	Gross change of domestic assets and liabilities				+	Gross change of external assets and liabilities		
“		“		“		“		“		“			“				“		
$(S - I)_{Emp}$	=	$PIBE_{Emp}$	-	WE_{Emp}	+	$OINE_{Emp}$			-	FKE_{Emp}	=	+	ΔAIB	-	ΔPIB	+	ΔAEB	-	ΔPEB
$(S - I)_{SF}$	=	PIB_{SF}	-	W_{SF}	+	OIN_{SF}			-	FK_{SF}	=	+	ΔAIB	-	ΔPIB	+	ΔAEB	-	ΔPEB
$(S - I)_{Gob}$	=	PIB_{Gob}	-	W_{Gob}	+	OIN_{Gob}	-	CF_{Gob}	-	FK_{Gob}	=	+	ΔAIB	-	ΔPIB	+	ΔAEB	-	ΔPEB
$(S - I)_{Hog}$	=	PIB_{Hog}	+	W_{Hog}	+	OIN_{Hog}	-	CF_{Hog}	-	FK_{Hog}	=	+	ΔAIB	-	ΔPIB	+	ΔAEB	-	ΔPEB
$(S - I)_{ISFL}$	=	$PIBIO_{ISFL}$	-	WI_{ISFL}	+	OIN_{ISFL}	-		-	FK_{ISFL}	=	+	ΔAIB	-	ΔPIB	+	ΔAEB	-	ΔPEB
$(S - I)_{Tot}$	=	PIB_{Tot}	+	0	+	TEN_{Tot} b/	-	CF_{Tot}	-	FK_{Tot}	=	+	$\Sigma\Delta AIB$	-	$\Sigma\Delta PIB$	+	$S\Delta AEB$	-	$S\Delta PEB$
$(S - I)_{Tot}$	=	PIB_{Tot}	+	0	+	TEN_{Tot} b/	-	CF_{Tot}	-	FK_{Tot}	=		0			+	$S\Delta AEB$	-	$S\Delta PEB$

a/ Includes: a) Net domestic and foreign income from production factors: interest, dividends, yield; b) Net social security contributions and benefits; c) taxes on income and wealth; d) net transfers: transfers by the general government and remittances.
b/ Net foreign transfers: includes net payment to factors abroad and remittances.
Conventions: Tot = total economy; Com = Companies; FS = financial system; Gov = general government; Hoh = households; NFPI = Not for profit Institutions
Source: Banco de la Republica

Table B1.1
Colombia's National Accounts: Results by Institutional Sector 2020
(billions of pesos)

		Non-financial Corporations (S11)	Investment banks (S12)	General Government (S13)	Households (S14)	NFPI	Total economy (S1)	Rest of the world (S2)
B6b	Gross available income	108,653	12,922	115,737	781,885	4,261	1,023,458	0
P.3	Final consumption	0	0	177,691	696,938	3,933	878,562	0
B8b	Gross Savings	108,653	12,922	(61,954)	84,947	328	144,896	0
P5	Gross Capital Formation and net acquisition of non-produced assets	119,402	(17)	27,666	43,305	307	190,663	0
B.9	**Net non-financial loans**	**(10,883)**	**7,107**	**(87,506)**	**45,494**	**21**	**(45,767)**	**45,767**
	Statistical discrepancy	10,502	3,579	2	140	1,694	15,916	(15,916)
B.9	Net financial loans	**(381)**	**10,686**	**(87,504)**	**45,634**	**1,715**	**(29,851)**	**29,851**
	Total increase in financial assets	37,850	130,429	57,210	71,732	853	298,074	88,924
	Total increase in liabilities	38,231	119,743	144,714	26,099	(862)	327,925	59,073
F1	Monetary gold and special drawing rights: net flow	0	(2,626)	0	0	0	(2,626)	2,626
F2	Cash and deposits: net flow	24,975	(66,211)	18,359	40,369	1,414	18,906	(18,906)
F3	Debt securities: net flow	(8,149)	36,125	(72,932)	8,594	334	(36,027)	36,027
F4	Loans: net flow	(11,349)	41,306	(41,270)	(22,001)	778	(32,535)	32,535
F5	Stocks, trusts, and fiduciary services: net flow	14,122	178	5,426	2,878	(19)	22,587	(22,587)
F6	Insurance and private pension funds: net flow	1,708	(11,186)	1,288	8,754	0	564	(564)
F8	Accounts Receivable or Payable: net flow	(21,688)	13,099	1,624	7,039	(793)	(719)	719

Source: *Banco de la República* and DANE.

Table B1.2
Colombia's National Accounts: Results by Institutional Sector 2020
(change with respect to 2019 in billions of pesos)

		Non-financial Corporations (S11)	Investment banks (S12)	General Government (S13)	Households (S14)	NFPI	Total economy (S1)	Rest of the world (S2)
B6b	Gross available income	6,276	(4,638)	(41,068)	(1,805)	(256)	(41,491)	0
P.3	Final consumption	0	0	10,484	(26,314)	(209)	(16,039)	0
B8b	Gross Savings	6,276	(4,638)	(51,552)	24,509	(47)	(25,452)	0
P5	Gross Capital Formation and net acquisition of non-produced assets	(15,965)	2,860	(12,165)	(12,259)	(48)	(37,577)	0
B.9	**Net non-financial loans**	**22,379**	**(244)**	**(44,203)**	**34,192**	**1**	**12,125**	**(12,125)**
	Statistical discrepancy	(3,293)	3,223	22	(40)	1,486	1,397	(1,397)
B.9	**Net financial loans**	**19,086**	**2,979**	**(44,181)**	**34,152**	**1,487**	**13,522**	**(13,522)**
	Total increase in financial assets	15,707	21,266	49,968	12,974	(1,018)	98,897	32,363
	Total increase in liabilities	(3,379)	18,287	94,149	(21,178)	(2,504)	85,375	45,885
F1	Monetary gold and special drawing rights: net flow	0	(2,542)	0	0	0	(2,542)	2,542
F2	Cash and deposits: net flow	19,725	(28,324)	23,129	17,684	847	33,062	(33,062)
F3	Debt securities: net flow	(3,949)	7,278	(36,510)	5,324	113	(27,744)	27,744
F4	Loans: net flow	(4,547)	3,132	(43,903)	17,540	860	(26,919)	26,919
F5	Stocks, trusts, and fiduciary services: net flow	18,947	5,282	10,758	1,701	(114)	36,574	(36,574)
F6	Insurance and private pension funds: net flow	3,626	(534)	(565)	(1,872)	0	656	(656)
F8	Accounts Receivable or Payable: net flow	(14,716)	18,687	2,909	(6,226)	(219)	435	(435)

Source: *Banco de la República* and DANE.

income (associated with the reduction in tax revenue and the increase in transfers) and COP 10.5 b in higher final consumption spending which meant a COP 51.6 b decline in savings. This was partially offset by the lower spending on capital formation of COP 12.2 b (Tables B1.1 and B1.2).

With respect to households, the surplus in their net lending (4.5% of the GDP) represented a COP 34.2 b (3.5 pp of the GDP) increase compared to 2019. The above was the result of an increase in household savings which grew COP 24.5 b mainly due to the drop in consumption and the reduction in capital formation (housing, in particular) that fell COP 12.3 (Tables B1.1 and B1.2).

Moreover, the net financial loan calculated by the Bank shows that the economy presented a deficit of 3.0% of GDP in 2020. This was mainly because of the general government deficit that was equivalent to 8.7% of the GDP and was partially offset by the households' (4.6% of the GDP) and investment banks' surplus (1.1% of the GDP).[4]

The central government's higher deficit in 2020 was mainly covered by means of the issuance of COP 72.9 b in debt securities and COP 41.3 b in borrowed money that was partially offset by accumulated net deposits of COP 18.4 b. Colombian households, in turn, acquired COP 71.7 b in financial assets, and their liabilities only rose 26.1 b (Tables B1.1 and B1.2).

4. Institutional sectors' annual net financial lending changes, 2016-2020[5]

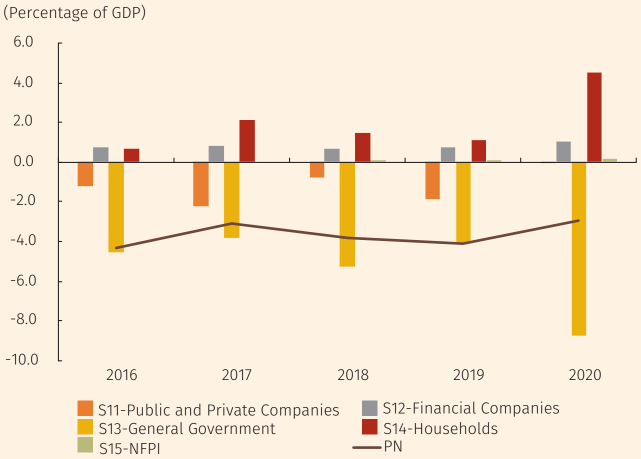
The Colombian economy has run a deficit between 2016 and 2020 with net financial loans that fluctuated between 3.0% and 4.3% of the GDP as calculated by the Bank. The sector with the largest deficit was the general government, followed by the non-financial corporate sector. In contrast, the surplus sectors have been households and financial corporations in that order (Graph B1.1).

Between 2016 and 2019, the Colombian economy's current account deficit was financed through capital inflows that mainly consisted of debt securities, loans and equity stakes. In 2020, there were capital inflows through debt securities and loans, and capital outflows due to deposits and net increase in foreign equity investments (Graph B1.2).

4 The discrepancy between the net loan calculated by the Bank and Dane comes from differences in the sources and coverage of information, differences in methodological treatment and the existence of errors and omissions in the balance of payments. See the methodological documents referenced in note 1.

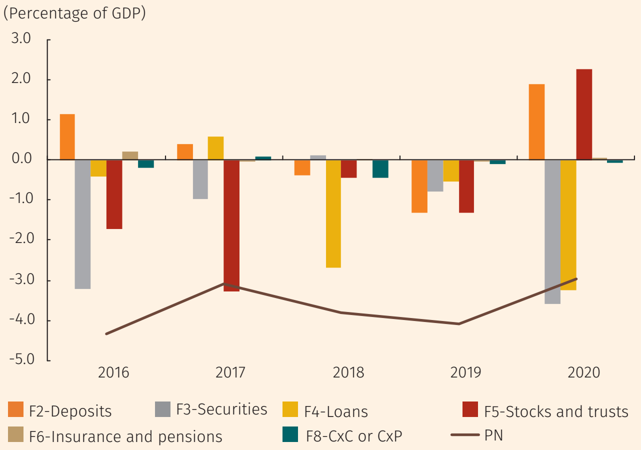
5 The results between the first quarter of 2016 and the first quarter of 2021 under the 2008 SNA methodology are available. (https://www.banrep.gov.co/es/estadisticas/flujos-cuentas-financieras-scn-2008).

Graph R1.1
Colombia's Annual Net Financial Loans by Institutional Sectors, 2016-2020



Source: *Banco de la República*, authors' calculations.

Graph R1.2
Current Account Financing by Financial Instrument, 2016-2020



Source: *Banco de la República*, authors' calculations.

5. Conclusion:

The results of this quarterly national account project by institutional sector provide the country's authorities, and the general public, with a timely and much deeper understanding of the economy. They show the performance of the main economic agents over time, the interrelationship between the real and financial sectors, and contribute to the understanding of vulnerabilities that may reside in particular sectors. Similarly, sector accounts and balance sheets facilitate the international comparability of statistics.

Box 2
Direct Credit from the Central Bank to the Government

In Colombia, as in many countries, the Covid-19 pandemic led to a sharp deterioration in public finances. Between 2019 and 2020, the central national government (CNG) deficit went from 2.5% to 7.8% of the GDP and the gross debt as a share of output rose 14.5 percentage points (pp) and reached a level of 64.8% of the GDP. The medium-term projections indicate that the CNG deficit will probably continue rising in 2021 and reach 8.6% of the GDP before declining from 2022. Gross debt will probably reach 69.1% of the GDP in 2023 and, from that point, is likely to decline slowly. The size of both the deficit and debt are the highest ones registered to date.

In this difficult fiscal situation, some sectors have suggested that *Banco de la República* offer direct credit to the government through monetary issuance. At first glance, it seems to be an easy and low-cost option, so it is important to analyze this proposal to understand the risks involved. To this end, three types of considerations, which complement each other, should be kept in mind: 1) interpretation of the Constitutional mandate; 2) international experience; 3) pragmatic analysis of its advisability.

Concerning the interpretation of the constitutional mandate, the possibility of *Banco de la República* granting direct credit to the government was widely discussed by the members of the 1991 Constituent Assembly. The final decision was to leave it open, but subject to one condition: the unanimous favorable vote of the members of the Board of Directors. Placing this condition on it was a way of saying that the mechanism could be used only in extraordinary conditions in which there was no better option. The current situation, in which the government has obtained the necessary financing resources, is not one of these. So much so that, last year, CNG opted to pre-finance part of the 2021 needs by taking advantage of the market window that allowed suitable financial conditions. So far in 2021, bonds have been placed multiple times on the international capital markets at low-interest rates, and this has served to finance the large fiscal deficit and replace bonds maturing soon. The domestic public debt market, in turn, has kept up a sufficient flow of TES placements in both pesos and UVR, and with this, a significant portion of the public deficit is financed.

In terms of international experience, no advanced country uses direct credit from the central bank to finance the government. When quantitative easing was used in the past, the monetary authorities made purchases of public bonds in the secondary market and were very careful to state that the policy was not intended to finance the government but rather to combat a drop in inflation and support the economy. That is why the public clearly understood that the initiative was not fiscal, and this allowed the central banks to preserve their credibility and hold to monetary discipline.

Among emerging economies, direct credit from the central bank to the government is considered a bad practice since it means subjecting monetary policy to fiscal goals, and a different logic should guide those. In Latin America, the main economies with autonomous central banks (Mexico, Brazil, Chile, Peru, and Uruguay for example) have abandoned this practice. A few countries continue to use it, but they are getting rid of these direct credits to acquire greater international credibility, and, in this transition, they have had to resort to adjustment programs with the International Monetary Fund (IMF). Others, like Venezuela, have used primary credit as a source of public financing at the cost of dealing with the total loss of monetary control. This has led to hyperinflation that destroyed the effectiveness of their monetary system.

Many advanced countries and many emerging economies with autonomous central banks indirectly finance the government by purchasing public debt securities on the open market. This mechanism is used under the criteria of monetary policy. These criteria are to keep inflation around the target, support sustainable economic growth, and contribute to the preservation of financial stability. The latter is the path that Colombia has taken. For example, one part of the expansion of the monetary base was carried out in 2020 through the purchase of TES in the secondary market. This was linked to other sources of monetary issuance (such as the transfer of profits to the government) that contributed significantly to the financing of the fiscal imbalance without jeopardizing the credibility of monetary policy or the general framework of the Colombian economic policy.

Finally, in a pragmatic and suitability analysis, it should be noted that the national government has built up a reputation and credibility with its management of debt after many years of fiscal compliance and prudence. Many institutional investors worldwide including pension funds, investment banks, and mutual funds buy the bonds issued by the Colombian government and thus help meet the financing needs that cannot be covered by current tax revenue. In the local public debt market, confidence and credibility in debt sustainability have been equally important. Hundreds of thousands of Colombians have investments in TES, either directly or through financial intermediaries or their pension funds. In the local capital market, the TES is considered a safe asset and, therefore, has the lowest interest rate in the market. In addition, today, 25% of the TES balance is in the hands of foreigners who tend to ask for more than is issued.

That is why, under the current circumstances, there would be a high cost in terms of joint credibility for both the central bank and the government if the government got direct credit from *Banco de la República*. This could make public borrowing substantially more expensive or limit the government's access to this financing. The Covid-19 crisis and the transition to a more equitable society have costs that must be covered using all the available fiscal policy tools. These include efforts to increase revenue, austerity, and spending efficiency as well as responsible public borrowing. If these approaches are left aside and, instead, the attempt is made to cover these expenditures with the issuance, a serious dependence of monetary policy on fiscal policy could be generated. This could eventually lead to inflationary pressure or a macroeconomic crisis with costs typically paid by the poorest.

Appendix
Management Policy for the Foreign Reserve Investment Portfolio

According to good practice recommendations, the management of foreign reserves should be based on liquidity, risk management, and profitability criteria. In that respect, an attempt must be made to: 1) have enough liquidity in foreign currency, 2) have strict policies regarding the management of the different risks that the transactions face, and 3) generate reasonable, risk-adjusted returns subject to liquidity and other risk restrictions.[1] How these rules are applied in the management of Colombia's foreign reserves is explained below.

1. Risk Management Policy

Banco de la República has a framework for risk management that identifies and assesses the risks to which their transactions are exposed in order to keep them low. Some of the main policies for risk management are as follows:

Liquidity Risk: the portfolio is divided into tranches and investments are made in financial assets that are permanently in demand on the secondary market. This is done in order to have the ability to convert reserve assets into cash rapidly and at a low cost, and so that some of the defined tranches can be liquidated faster.

Market Risk: investments are made into a limited group of eligible assets with strict investment limits on duration, spread duration, foreign exchange composition, and breakdown of the portfolio by sector. The goal is for the value of the portfolio to be moderately sensitive to interest rate movements in the market.

Credit risk: investments are only made in assets with high credit ratings given that these investments have a low probability of defaulting on their payments. The minimum credit rating for governments and entities related to governments is A-. With respect to private issuers, the minimum rating is A+ for exposure to individual issuers, and BBB- (investment grade) when the investment is done through funds. Historically, the percentage of issuers with these ratings that have defaulted on their payments the year after is close to 0%. If the rating of an issuer that the portfolio has invested in directly drops below the minimum allowed, the exposure is liquidated within a short period of time. Moreover, the maximum exposures are limited by sector and issuer in order to limit the impact of credit events on the value of the portfolio.

Exchange risk: The impact of the foreign exchange risk is mitigated by the "foreign exchange adjustment" equity account that is dealt with under Decree 2520/1993 number 4 of article 62 (Statutes of *Banco de la República*). This account rises during those years when reserve currencies become stronger with respect to the Colombian peso and decline in those years when they weaken. Therefore, the variations in the currencies do not have any impact on the consolidated profit or loss statement. *Banco de la República*, like the majority of the central banks around the world, has currencies other than the US dollar as part of their currency components in order to cover the country's payments abroad since these are made in many currencies. It is important to keep in mind the fact that the prices of the currencies are highly volatile and do not often have defined long-term trends. This makes it very difficult to reliably predict their behavior.

Counterparty risk: To mitigate the counterparty risk, transactions are settled through payment on delivery mechanisms. Counterparties in fixed income trading are required to be market makers, and the counterparties in currency trading are required to have high credit ratings. The purpose for payment on delivery mechanisms is to make the exchange of papers for cash or exchange of payments in a foreign currency exchange transaction a simultaneous one in order to eliminate the possibility of a default by one of the parties to the trade. The foreign currency exchange counterparties must have a minimum credit rating of A- if they have an ISDA contract.[2] If they do not have said contract, the minimum rating is A+.

1 One example of good practice in this respect can be found in the document "Guidelines for the Management of Foreign reserves," produced by the International Monetary Fund, which can be consulted at this link http://www.imf.org/external/np/sec/pr/2013/pr13138.htm

2 The purpose of the contract established by the International Swaps and Derivatives Association (ISDA) is to establish the terms and conditions that govern over-the-counter derivatives traded between entities.

2. Tranche of the Investment Portfolio

The investment portfolio is made up of three tranches: the short term, the medium term and the gold tranche.

The purpose of the short-term tranche is to cover potential liquidity needs from the reserves in twelve months. Currently, this tranche consists of working capital and a passive portfolio. The working capital is the portfolio into which the funds that come from intervention in the exchange market are placed and their investments are concentrated in very short-term assets denominated in dollars. Given that the objective of this tranche is to provide immediate liquidity for intervention in the foreign exchange market, the working capital is concentrated in deposits and investments that can be liquidated in one day at a very low cost. As of June 2021, the value of the short-term tranche was USD 31,353.1 b, of which USD 1,087.2 m corresponded to working capital and USD 30,265.9 b to the passive portfolio.

The passive portfolio is the main component of the short-term tranche. This portfolio is characterized by an investment horizon and a profile of expected profitability that are higher than those of the working capital portfolio. In addition, it has a foreign exchange breakdown that is intended to replicate the performance of the country's balance of payments' outflows, and a profitability that is similar to that of its benchmark.[3] The passive portfolio is invested in multiple currencies and instruments that are in line with those in a benchmark defined under the restrictions that the expected return on the portfolio, excluding the foreign exchange component, must be positive in 12 months with a confidence level of 95% and that the expected value of a possible loss must not exceed 1.0%.

The medium-term tranche is intended to raise the expected profitability of the foreign reserves in the long term while preserving a conservative portfolio with a profile of expected profitability that is higher than the short-term tranche and the benchmark. Its goal is to maximize the risk-adjusted return in US dollars, the currency in which foreign reserves are valued, for the portion of the portfolio that is less likely to be used within a twelve-month period. Thus, the maximum return is sought subject to the restriction that the expected return in US dollars for this tranche be positive with a 95% probability, and that the value expected from a possible loss does not surpass 1.0% over a horizon of three years. Currently, the majority of the medium-term tranche consists of actively managed portfolios that seek to generate a return that is higher than the benchmark.[4] As of June 2021, the value of the medium-term tranche came to USD 25,006.8 m.

The last tranche corresponds to the foreign reserve investments in certified physical gold that can be easily traded on international markets. Gold makes it possible to diversify the investment portfolio since its price behaves differently than prices of the investments in the short- and medium-term tranches. As of June 2021, the market value of gold in the reserves came to USD 266.2 m.

The securities in the investment portfolio are deposited in financial institutions known as custodians.[5] The entities that provide custody service for the securities in the foreign reserves are the New York Federal Reserve, Euroclear, JP Morgan Chase, and State Street. The investments in physical gold are in the custody of the Bank of England.

3. Benchmark indices

To manage the reserve investment portfolio, *Banco de la República* has defined theoretical portfolios or benchmarks[6] for short- and medium-term tranches. Different indices are built for each one of these tranches in order to reflect their investment goals. The indices serve as a frame of reference to measure the management of each one of the portfolios. The way the two benchmark indices are built is explained below.

In order to build the short-term tranche benchmark,[7] first of all, a target foreign exchange breakdown is determined. Once the foreign exchange breakdown is defined, a portfolio is sought that maximizes the risk-adjusted return[8] and complies with the loss restrictions defined for this tranche. The foreign exchange breakdown for this index is intended to replicate the trend of the outflows from the country's balance of payments.[9] The goal is for the currencies other than the US dollar to appreciate during periods in which the dollar value of the country's payments abroad increases, which would mean that the value of these foreign currencies could decline with respect to the US dollar during periods in which the dollar value of the foreign payments decreases. As of June 2021, the foreign exchange breakdown of the short-term tranche benchmark was 82% US dollars, 8.0% Australian dollars, 5.0% Canadian dollars, 1.0% New Zealand dollars, 2.0% Norwegian krone, and 2.0% Korean won. The loss restrictions defined for the short-term tranche are: 1) having positive returns over a horizon of twelve months with a 95% level of confidence while excluding the exchange rate effect and 2) that the expected value of a possible loss

3 The concept and components of the benchmark will be explained in the next section.

4 The fact that one of the seven active portfolios is managed directly by Banco *de la Republica* and the rest by external managers is explained in the section, "External Management Program." An explanation on how this program functions can also be found there.

5 Currently, the minimum credit rating allowed for the custodianscxz< is A-.

6 In capital markets, a benchmark refers to a basket of assets with predetermined weights in accordance with certain rules that define their components. In general, a benchmark tries to comprehensively duplicate the trend of a financial asset market and serves as an indicator of the performance of other investment portfolios in the same market. For example, some of the best-known benchmark indices on the stock markets are the COLCAP in Colombia, or the S&P500 and the Dow Jones in the United States (the Bank uses fixed income market indices only).

7 This benchmark does not apply to the working capital since there are no benchmark portfolios that make it possible to properly measure the instruments allowed in this portfolio.

8 A detailed description of the methodology for building the benchmark is in the sections entitled "Technical Explanation of the Methodology for Building the Benchmark Index" and "Market Risk Restrictions on the Optimization Process" in the 2013 and 2019 Management Reports on the Foreign reserves.

9 See section, "International-reserve Portfolio's New Foreign Exchange Components in the March 2012 Report to Congress for a detailed explanation of the methodology for the foreign exchange breakdown of the reserves.

over a horizon of twelve months does not exceed 1.0% of the value of the tranche.

To build the benchmark of the medium-term tranche, a similar procedure is followed with two basic differences: no restriction is imposed on the foreign exchange breakdown and the loss restrictions are defined over a longer horizon. Firstly, no currency exchange breakdown restriction is imposed given that the goal of this tranche is to maximize the risk-adjusted return in US dollars. Secondly, the restriction of having positive returns at a 95% confidence level and that the expected value of a possible loss does not exceed 1.0% of the value of the tranche is defined for a horizon of three years is intended to reflect the lower probability of using the funds in this tranche in the short term. When building a portfolio that maximizes risk-adjusted profitability in dollars, investments in currencies other than the dollar are allowed.

As of June 2021, the benchmarks defined for the two tranches have a low level of market risk with an effective duration of 0.76 for the short-term tranche benchmark and of 1.52 for the medium-term benchmark.[10] Graph A1.1 shows the benchmarks approved for the short- and medium-term tranches.[11]

4. External Management Program

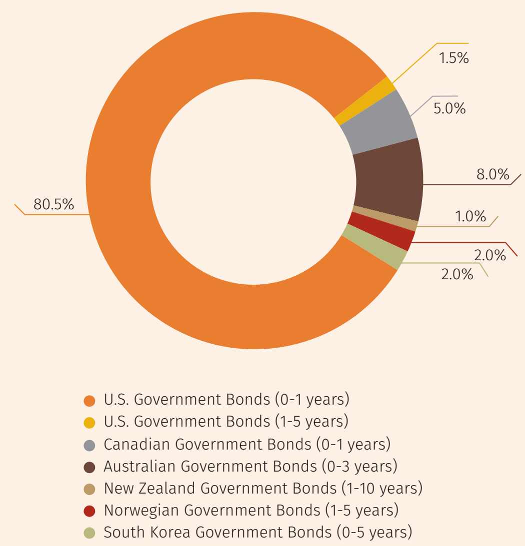
Banco de la República manages the short-term tranche, a portion of the medium-term tranche, and the gold tranche directly. The remaining medium-term tranche funds are managed by external portfolio managers. At the end of June 2021, the portion of the investment portfolio that is managed internally corresponded to USD 40,302.3 m (71.1% of the investment portfolio) while the external management program came to USD 16,323.9 m (28.9% of the investment portfolio).

The main reasons for using external managers are to generate returns that are higher than the benchmark and to improve the diversification of the portfolio. In this respect, the firms chosen to participate in the program have ample experience in the analysis of financial markets and have a sophisticated infrastructure that can benefit the definition ofinvestment strategies and the training of Bank officials in the management of international investments. The latter is another objective of the external management program.

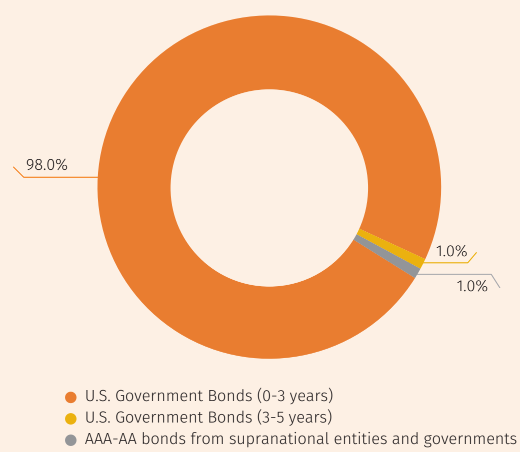
The private firms that participate in the program are chosen through a competitive selection process and continuously evaluated. The amount of assets under management and the continuation in the external management program are tied to the results obtained by each administrator in the evaluation process. The private companies that participate in the external management program currently are: DWS International GmbH, Goldman Sachs Asset Management, L.P., J.P. Morgan Asset Management (UK) Limited, Pacific Investment Management Company LLC, State Street Global Advisors Trust Company, and UBS Asset Management, Americas) (Graph A1.2). The funds that these companies manage are in *Banco de la República's* custody accounts and the administrators' contracts can be canceled whenever considered necessary. The investments in funds managed by the Bank for International Settlements (BIS) are also

Graph A1.1
Breakdown of the Benchmark Index
(information as of June 30, 2021)

1. Short-term Tranche



2. Medium-term Tranche



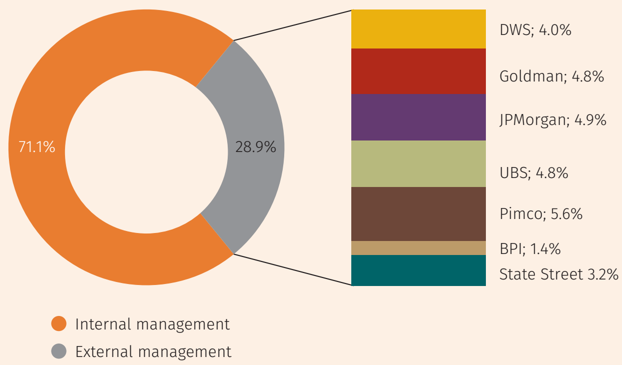
Source: *Banco de la República*

10 The effective duration is a measure of risk defined as a percentage decrease (increase) in the value of the portfolio with respect to a 1.0% increase (decrease) in the interest rates.

11 For the different sectors that the benchmark index is made up of, the indices published by ICE data indices are used.

considered part of the external management program. Only central banks and multilateral entities have access to these funds, and the purpose for them is to invest in the assets that are appropriate for global foreign reserves in an effort by different countries to work cooperatively.[12]

Graph A1.2
Management of the Investment Portfolio
(information as of June 30, 2021)



Note: approximate values due to rounding.
Source: *Banco de la República*

12 At present, the investments are made in a fund of inflation-indexed securities issued by the Treasury of the United States (USD 128.9 m), a fund of securities issued by the government of China (USD 293.4 m) a fund of securities issued by the government of Korea (USD 110.7 m) and a fund of securities issued by non-financial corporations (USD 279.7 m).

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