



MONETARY POLICY IN COLOMBIA: Is Inflation Targeting the appropriate strategy in the current crisis?

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Outline

- **Recent Trends in CPI Inflation**
- **Monetary Policy Response**
- **Growth Deceleration and its Causes**
- **FX Intervention and External Vulnerability**



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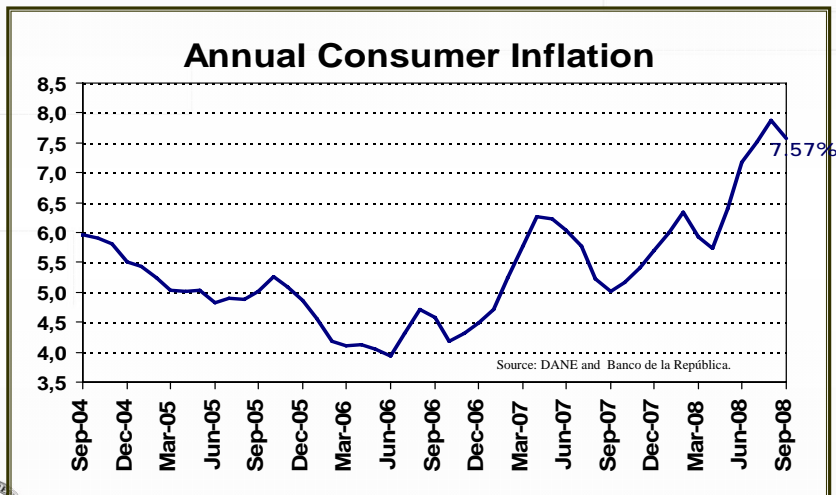
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Annual CPI inflation in September was 7.6%.
Lower than in August but more than 300 bp above the ceiling of the range target (3.5%-4.5%).



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Large increase in inflation is mainly explained by supply shocks in food prices

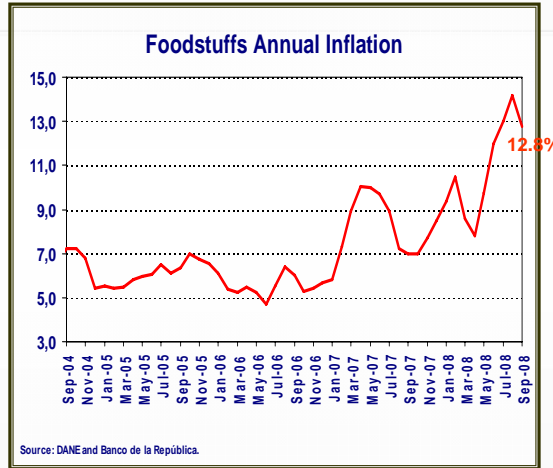
Food price inflation:

5.9% in December 2006

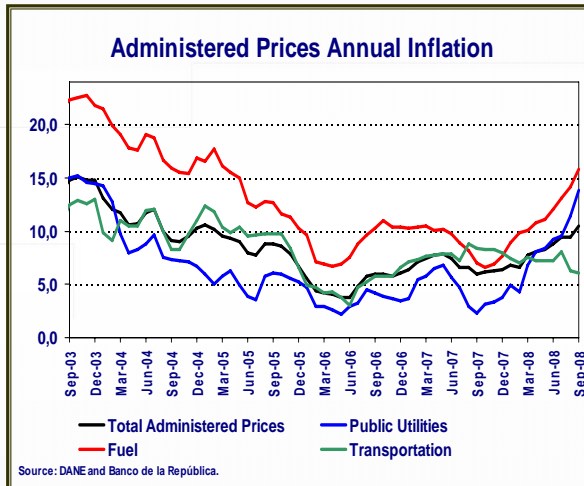
8.5% in December 2007

14.2% in August 2008.

Recent decline in total CPI inflation was explained by a fall in food inflation to 12.8% in September.



The rise in food prices in 2008 has been reinforced by higher energy prices and by the indexation system of tariffs in public utilities



The rate of growth of Administered Prices went up from 6.4% in December 2007 to 10.4% in September 2008

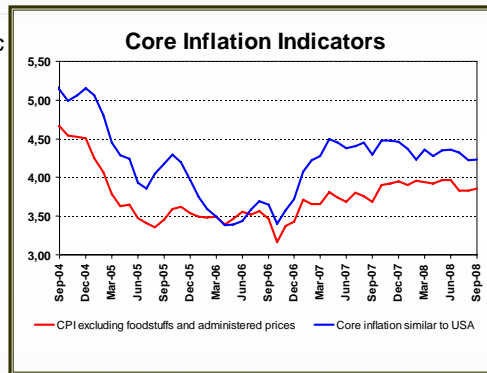


Core Inflation: Excluding foodstuff and administered prices

- 60% of CPI basket
- Better indicator of macroeconomic pressures on prices

Recent behavior:

1. Upward trend between mid- 2006 and 2007, signaling excess demand
2. Stability around 4% (the mid-point of our range target) since the last quarter of 2007 and small decline (to 3.9%) after July 2008.



→ Inflation targeting has been successful in avoiding propagation of shocks in commodity prices.



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Lower commodity prices in the near future provide an opportunity to resume a declining path in inflation towards our long run target (of $3\% \pm 1\%$)

Although excess demand is already under control, resuming a declining path in inflation requires a very prudent monetary policy.

Risks on Inflation prospects:

- Wage indexation to lagged inflation
- Pass-through effects of COP depreciation
- Propagation from lagged effect of high producers costs (associated with past behavior of commodity prices)

→ **The big challenge is keeping control on inflation expectations and recovering confidence in central bank targets.**



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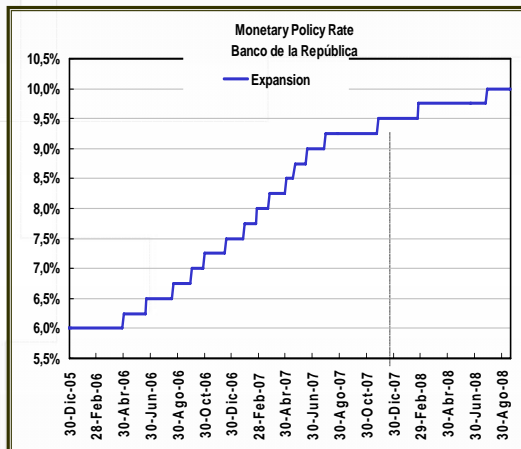
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Two different periods in the upward process of adjustment of the monetary policy interest rate



1. **Between April 2006 and December 2007:**
 - 14 adjustments
 - Interest rate goes from 6% to 9,5%
2. **During 2008**
 - Only 2 adjustments
 - Interest rate goes from 9.5% to 10%



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Rationale for interest rate hiking in 2006 and 2007

- Rate of growth of domestic demand close to 10% in real terms, much higher than any estimate of potential growth of the Colombian economy.
- Real credit growth close to 30% (and higher than 40% for consumption loans), which was not only a threat to inflation targeting but also to financial stability.
- Upward trends in both CPI inflation and core inflation.
- Deterioration in current account balance in the BOP, which showed a deficit of 3.4% of GDP in 2007, despite record highs in export prices

→ **Overall evidence of excess demand in the economy**



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¿What about 2008?

- Rapid adjustment in the rate of growth of domestic demand, which in real terms went down from 9% in 2007-4, to 5.7% in 2008-1 y a 4.2% in 2008-2.
- Convergence in real credit growth to rates around 10% for total loans and to even lower rates for consumption loans. Still dynamic but not worrisome.
- Current account deficit expected at around 2.2% of GDP, much lower than in 2007
- Stability in core inflation (excluding foodstuff and administered prices).

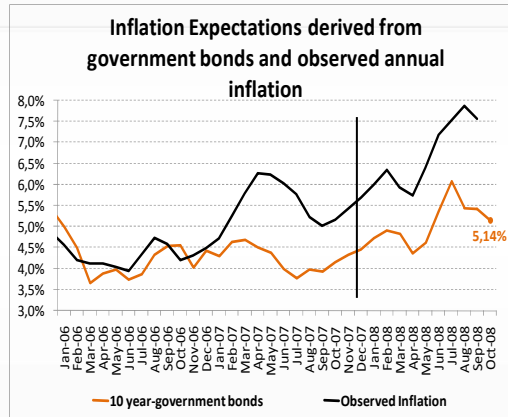
¿Why, then, has the Banco de la República increased interest rates twice in 2008?



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Rationale for the increase in interest rates in 2008: Expectations and Credibility

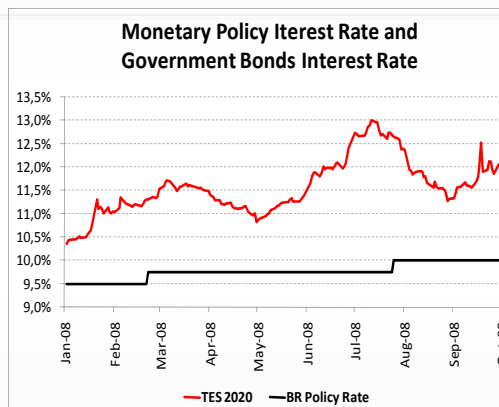
- Credibility eroded by non-fulfilment of 2007 target
- External shock in commodity prices led headline inflation close to 8% in August, 2008
- Risk of propagation
- Rapid increase in inflation expectatios, not only for 2008 but for the longer run.



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Market (long-run) interest rates vs policy (short-run) rates

- Inflation expectations in 2008 increased long run (market) interest rates.
- Adjustments in the short-run (policy) rates in March and July were helpful to recover confidence in inflation control and reduced long-run interest rates.



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Summarizing....

- **The upward adjustments in policy interest rates in 2008 (in contrast with those of 2006 and 2007), did not respond to any evidence of excess demand in the Colombian economy**
- **They were addressed to keep inflation expectations under control and mitigate the risks of propagation of the price shock in commodities.**
- **As expected, the increments in policy interest rates under these conditions helped to avoid larger increases in long-run market rates.**



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Figures of GDP growth in 2008 evidence a faster deceleration than expected, from 7.7% growth in 2007 to 4.1% in the first half of 2008



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Causes of growth deceleration

1. Higher interest rates
2. Temporary fall in public works, due to change in territorial governments last January
3. Lower growth of exports to Venezuela
4. Crowding-out effect of higher food and energy prices on households spending
5. Negative impact of currency appreciation on tradable sectors

The effects of the international financial crisis and of the growth deceleration in the world economy are not yet evident in the Colombian economy



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Public works were growing 30% in the first half of 2007 and showed a negative growth (-14%) in the first half of 2008

Gross domestic product (Annual growth)

Excluding the direct effect of public works, GDP growth in the first half of 2008 was 4.7% instead of 4.1%.

| | 2007 | jan-jun -2007 | jan-jun -2008 |
|---|------------|---------------|---------------|
| Agriculture, forestry, fishing, and hunting | 3.4 | 3.4 | 3.7 |
| Mining | 2.7 | 2.1 | 6.2 |
| Manufacturing | 9.5 | 11.4 | 1.6 |
| Utilities | 3.3 | 3.8 | 1.2 |
| Construction | 13.9 | 19.6 | 0.5 |
| Residential and comercial construction | 1.2 | 5.2 | 25.5 |
| Civil engineer construction | 23.4 | 30.2 | -14.1 |
| Wholesale and Retail trade | 9.9 | 10.7 | 3.4 |
| Transportation and warehousing | 10.1 | 9.3 | 6.0 |
| Finance, insurance, real estate, rental, and leasing | 6.7 | 6.3 | 6.1 |
| Professional, business and Government services | 3.9 | 3.1 | 3.3 |
| Value added | 7.1 | 7.5 | 3.7 |
| Taxes | 15.0 | 16.4 | 7.7 |
| Gross domestic product | 7.7 | 8.2 | 4.1 |
| Gross domestic product without civil engineer construction | 7.3 | 7.6 | 4.7 |

Source: DANE



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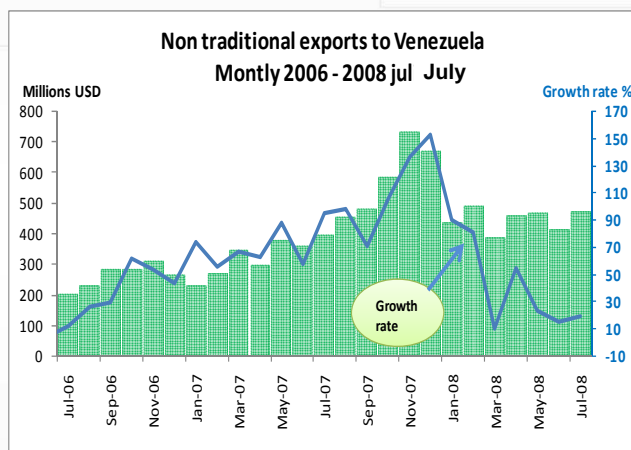
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Although export growth rates to Venezuela are still high in annual terms, they are going down rapidly

Average monthly exports have gone down from **US\$ 660 millions** in the last quarter of 2007 to **US\$ 450 millions** in 2008.



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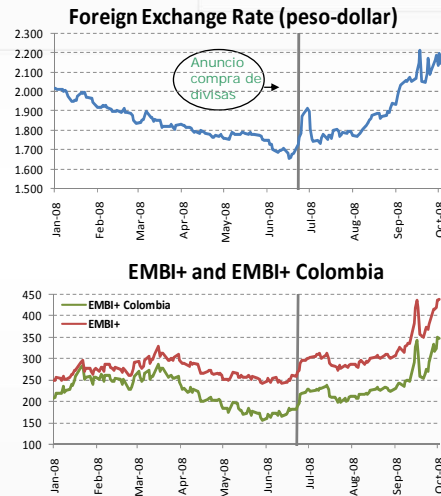
After a very deep process of appreciation of the peso,
it has been depreciating since last June

Two explanatory factors:

1. Announcement of daily purchases of US\$ 20 million by Banco de la República since June 24th.
2. Higher risk aversion, as measured both by EMBI-COL and EMBI-plus.

Daily purchases

- Acted as triggers of the depreciation.
- They have been useful to increase international reserves and to have a better cushion in current circumstances.
- They were suspended this week, as the Bank auctioned call options to deal with volatility (US\$180 million)



Five elements of strenght associated with
Colombian monetary and FX policy in order to deal
with the current crisis

- **Exchange Rate Flexibility**, which will allow this variable to help in the process of adjustment, provided that inflation is under control.
- **High levels of International Reserves**: close to US\$24 billion, compared to less than US\$11 billion in 2003, thanks to FX intervention during these years.
- **Low exposure to foreign debt and portfolio investment**, thanks to capital controls on inflows that were in place between May 2007 and last Thursday, and which make the Colombian economy less vulnerable to a sudden stop.
- **High but not excessive rate of growth of domestic credit**, thanks to the timely adjustment in monetary policy since April 2006.
- **Core inflation under control and good prospects to resume a declining path in headline inflation**, thanks to a flexible but persistent strategy of inflation targeting by the Banco de la República.



Thank You

