Responses to questions by Matthew Bristow from Bloomberg

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Q: The peso has weakened the most among more than 150 currencies since the election last month. How worried are you by this? Under what circumstances would intervention be appropriate?

A: Perhaps it is first worth highlighting that the performance ranking of currencies is highly sensitive to the sample period. For example, if we take the second half of May of this year, the Colombian peso was one of the most appreciated currencies (-8.3%), much more than Peru (-2%), Chile (-4.2%), and even Brazil (-6.6%). Having said this, of course the recent sudden and sharp depreciation of the Peso is among our many concerns, and particular caution must be placed in interpreting what it means/implies. In essence, exchange rates are driven by different factors depending on whether effects are short or long lived. In the short run, interest rate differentials and risk variables dominate. To illustrate, the faster hiking cycle conveyed by the US Federal Reserve affects most currencies by making them less profitable (through rate differentials) and by decreasing the level of risk appetite of most foreign investors. In addition, there are country-specific factors (such as country risk) that is also depreciating the peso vis-à-vis our regional trade partners. A key indicator for Colombia is the oil price, analogous to copper for Chile or soy for Brazil. In the Colombian case, oil prices usually (but not always) mirror the exchange rate as it carries implications for exports and fiscal revenue. In the long run, factors such as long-term inflation levels (through the purchasing power parity), the current account, and the fiscal debt sustainability are at play. In relative terms, Colombia underperforms in having larger and longer twin deficits (fiscal and current account deficits).

I personally do not think that FX interventions are appropriate under the current circumstances. FX interventions can be useful in correcting excessive movements (when exchange rate changes are fairly symmetric and not just in periods of depreciating winds) or in cases when liquidity in FX markets is low (like what occurred at the onset of the pandemic). Recall that the central bank does not target a specific exchange rate level. In fact, exchange rate flexibility pays dividends in absorbing shocks that would otherwise be reflected in other prices, and also allows for adjustments in the balance of payments. More generally, it allows central banks to have monetary autonomy (setting rates freely) while allowing for free capital flows. In economic jargon: having enough degrees of freedom so that the monetary trilemma does not bind.

Q: The currency has lost more than 10% of its value since you raised interest rates last month. How much pass-through would you expect to see from this? How much time would you expect to pass before this starts showing up in consumer prices? How big is the risk of second round effects?

A: In a counterfactual scenario, the exchange rate would have further depreciated (1.5 percentage points more) had we not increased the policy rate in 150 basis points. Keep in mind that the pass-through --from exchange rate to inflation-- depends on things like the economic cycle (more pass through if the GDP gap is positive), on the level of inflation (countries with higher inflation experience higher pass-throughs), and on the duration of the

currency depreciation (since for example firm's inventories or restaurant's menu costs can only temporarily resist price changes). The current scenario is somewhat bleak in all three determinants. Also, the lag effect, duration, and higher order round effects are highly uncertain.

Q: Colombia has about $70b in foreign currency debt. Obviously, the cost of the debt service is going to rise. Is that a concern? The central bank has about $58 billion in reserves. Is that an adequate amount given everything that's happening?

A: The level of foreign currency debt is definitely a concern. And not just due to a higher debt level brought about by exchange rate depreciations, but also because tighter external liquidity raises the cost of sovereign debt in foreign currency.

Regarding international reserves, the central bank constantly conducts various stress tests that include extreme scenarios of risk, including the possibility of large capital outflows, current account deficits and external debt services. While we cannot rule out future reserve accumulation, I would say that the strong macroeconomic and policy framework that we have today is consistent with the level of reserves, which is roughly 20% of GDP. To corroborate, according to the IMF measure of reserve adequacy, Colombia has 140% of its adequate level of reserves.

Q: The 10-year yield on TES has risen to 12.5%, from about 7% a year ago. What effect is that going to have on public finances, mortgage rates and home prices, corporate balance sheets, etc.?

A: Paradoxically, increases in the monetary policy rate can lessen the steepness of the yield curve, in some cases even reducing long term rates. The issue, however, is that many other factors affect the long part of the yield curve, including the country's risk premium which has been constantly deteriorating since the beginning of last year. In fact, before 2021, Colombia had a similar risk level to low-risk countries such as Peru, Chile and Mexico but today we are certainly in a higher risk tier group.

Regarding public and private finances, there should be a natural increase in loan rates since we began our hiking cycle in September 2021. But monetary transmission takes time, in some cases more than one year. There are other things that affect rates such as changes in the maturity and risk composition (this applies to both loans and deposits).

Nevertheless, by increasing rates we aim to intertemporally shift demand into the future by increasing savings and reducing borrowing. This is part of our inflation targeting toolkit. It will also better prepare us for a potential next crisis.

Fuente: https://www.banrep.gov.co/en/responses-questions-matthew-bristow-bloomberg