Speech by Leonardo Villar, Governor of Banco de la República, at the National Association of Financial Institutions (ANIF) General Assembly: "Radiography of the Colombian Economy: navigating in Times of Change"

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To begin, I would like to thank Mr. Mauricio Santa Maria, President of ANIF, and Mr. Miguel Largacha, Chairman of its Board of Directors, for the honorable invitation to participate in this event.

I would also like to highlight the opportunity to speak at this forum coinciding with the **centennial of *Banco de la República***, which took place on July 23, but which we have been celebrating along the year. As stated in the slogan we have coined for these celebrations, it has been **"100 years building trust"**.

These one hundred years since the founding of *Banco de la República* have also been a time to build confidence and a very solid **institutional** framework. This framework has been strong ever since the creation of the Bank in 1923, becoming even stronger with the 1991 Constitution, when *Banco de la República* became an autonomous institution with a very clear mandate to ensure the purchasing power of the currency in coordination with the Government to promote sustainable growth-and here I emphasize the word sustainable-of economic activity and employment.

The autonomy granted to *Banco de la República* by the 1991 Constitution, as well as the clarity of the mandate given to it, help to understand a great paradox. I am referring to the fact that the Bank is at the same time one of the organizations with the best public perception in Colombia, while also being a strongly unpopular and criticized institution whenever the Board of Directors of the Bank must make painful decisions that generate significant short-term costs in order to maintain medium- and long-term stability. It was precisely to better manage this apparent inconsistency between short- and long-term costs and benefits that *Banco de la República* was granted the autonomy that allows it to act with a broader time perspective than typically enjoyed by the governments in power and even by public opinion itself.

Contractionary monetary policy

The current monetary situation is a good example of a situation in which the Bank must make decisions that are painful in the short term to achieve greater and more lasting benefits in the medium and long term.

As you are well aware, *Banco de la República*'s policy interest rate was drastically increased in the one-and-a-half year period between September 2021 and April 2023. During this period, **a 11.5 pp increase** was completed, bringing the rate from 1.75% to 13.25%. This was the strongest monetary policy tightening process that has taken place during this century and also since the Bank adopted the inflation targeting strategy that

guides our decisions today.

The effects of this increase in interest rates on aggregate demand, imports, and credit, among other variables, began to be clearly felt as early as the last quarter of 2022, one year after we began tightening monetary policy. Those effects are generally painful and certainly unpopular. And what makes things more complex, the impacts on inflation occur with an even longer lag. Only in the first quarter of this year did we see that the upward trend in inflation began to slow down and only in April did we begin to see significant drops in this variable, from a peak of 13.3% to 10.5% last October. In turn, core inflation, measured as consumer price index (CPI) inflation excluding food and government-regulated prices, peaked at 10.5% in June and since that month has fallen systematically to 9.2% last October. In any case, it must be said that inflation is still at unacceptably high levels, far from the 3.0% target set by the Bank. We are only in the initial phase of the return to that target, which we expect will take place gradually but steadily over the next 12 to 18 months.

It seems relevant to highlight at this point that, although the increase in nominal policy interest rates during the last two years was very substantial, this was due to the dramatic increase in inflation. Real ex post interest rates, as measured by the differences between the nominal interest rate and observed inflation, are certainly higher today than they were at the time of the pandemic, but they are lower than what we had between 2017 and 2018 or at various points in the first decade of this century.

Productive activity and employment

Before discussing the factors that drove inflation to such high levels and giving some details on our outlook on that matter, I would like to make a few comments on the recent behavior of productive activity and employment.

The first thing I would like to point out is that productive activity and employment were much more dynamic and robust in 2021 and 2022 than anyone had imagined. **Real gross domestic product (GDP) growth was almost 11% in 2021 and 7.3% in 2022**. What happened in 2021 can be understood as the rebound after a dramatic fall in the year of the pandemic and is not too far from what happened in other countries. But the very high growth figure for 2022 is much more striking, both when viewed in historical terms and in comparison, with the rest of the world. Indeed, Colombia’s growth in 2022 was more than 3 percentage points higher than the average in Latin America, which the International Monetary Fund (IMF) estimates at 4.1%.

There is no doubt that such high growth of the Colombian economy in 2022 was positive. The problem is that it was an unsustainable growth rate, driven by excess demand. In fact, demand grew at a rate of over 10% in real terms that year, causing strong imbalances on different aspects.

- On the one hand, excess demand became a breeding ground for inflationary pressures, to which I will refer momentarily.
- On the other hand, such accelerated growth in demand could not be met with domestic production and was reflected in increased imports and a deficit in the checking account of the balance of payments, which for the full year was 6.2% of GDP. This imbalance is close to the historical maximum observed in Colombia. Only in 2015 did we have a similar one, but in that year, it was explained to a high degree by a very sharp fall in the prices of our exports. In 2022, on the other hand, such high deficit levels coincided with a very good performance of international oil, coal, and coffee prices, highlighting a particularly large vulnerability of the economy, which was spending much more than its revenues in a year of atypically high incomes.
- Likewise, the excess demand that characterized the Colombian economy in 2022 was manifested in consumer credit growth, which exceeded 23% in the third quarter of 2022, a rate much higher than the growth of household income. Had it continued, it would have generated an unsustainable situation on the households' ability to pay.

The tightening of monetary policy and the consequent increase in interest rates, as I said at the beginning, began to manifest itself from the last months of 2022 and much more clearly throughout 2023 in a lower dynamism of

demand and in an adjustment of the imbalances I just mentioned.

- Thus, the dollar value of imports went from growing at rates close to or above 40% up to August 2022 to showing negative annual growth rates as of November of that year. The current account deficit of the balance of payments fell from 6.2% of GDP in 2022 to 4.2% of GDP in the first quarter of 2023 and to only 3.0% of GDP in the second quarter of this year. For the year as a whole, the Bank's technical staff expects the deficit to be only 3.4% of GDP, significantly lower than last year's despite the fact that our export prices have fallen considerably. This lower external deficit means that Colombia now requires less international financing and makes the country much less vulnerable to international financial conditions, about which there is still great uncertainty.
- Regarding the behavior of domestic demand, it is clear that its growth rates slowed down considerably during the adjustment process. Its real growth was over 12% in the first half of 2022 and although it moderated in the second half of the year, it reached 9.2% for the full year. The figures in 2023 have been increasingly negative and according to what was released this week by the National Administrative Department of Statistics (DANE in Spanish) reached a negative percentage of -6.8% in the third quarter, considerably stronger than what the Bank's technical staff was forecasting. It should be noted that in this adjustment process, household consumption maintains positive growth rates, albeit low, and public consumption grew by 2.4% in real terms. The largest contraction is in gross capital formation, which according to the figures by DANE fell by slightly over 32% in the third quarter.
- The contraction in demand has implied a slowdown in productive activity that has been reflected particularly strongly in some sectors such as manufacturing and trade sales, where we have recently seen strongly negative growth figures with respect to the atypically high levels observed a year ago. For productive activity as a whole, the Bank's technical staff expected low growth in the third quarter, around 0.4%, but the data by DANE showed a contraction of -0.3%. This negative surprise will likely cause full-year GDP growth to fall short of the 1.2% figure projected by the technical staff in its October monetary policy report and possibly closer to the 0.9% that the same staff projected for the year as a whole three months ago.
- The adjustment process reflected in the figures I have just described is certainly painful, and I must say that the restrictive monetary policy adopted by the Bank has made a fundamental contribution to it. The adjustment of the Colombian Government public finances in line with the fiscal rule has also contributed to this process and will lead the Government's deficit, which reached 5.5% of GDP last year, to be reduced this year by more than one percentage point despite lower oil prices, the negative impact of the economic slowdown on tax revenues, and the higher interest payments that the government has to make in a context of higher local and international interest rates.
- However, it is important to note that even with GDP growth in the order of 0.9% this year, as can be inferred from a first analysis of the figures just released by DANE, activity levels in 2023 will be in line with those we would have seen if the pre-pandemic trends (with growth rates close to 3.0% per year) were maintained over the last four years. Indeed, if we compare cumulative Colombian GDP growth to pre-pandemic levels, our performance is largely favorable in relative terms vis-a-vis other countries in the region. In this respect, what we are observing this year can be understood as a process of return to levels of activity closer to sustainable ones, after a year (2022) in which demand growth was clearly much higher, causing significant imbalances in the balance of payments and serious inflationary pressures.
- It is also worth noting that, in the context of the recent slowdown in growth, the labor market is performing relatively well. The latest available data to September continue to show significant increases in the number of employed persons compared to a year ago i.e., 3.2% in the national aggregate and 2.2% in the thirteen main cities. In turn, unemployment rates remain at single-digit levels of 9.3% for the national aggregate and 9.6% for the 13 cities, the lowest since 2017, that is, several years before the pandemic.
- Certainly, unemployment rates as well as labor informality rates are excessively high in Colombia compared to other countries. This has been so for many years and should lead to a discussion on how to improve the conditions for the creation of formal employment. However, it should be noted that the strong macroeconomic adjustment being carried out has been compatible with avoiding impairment on this matter.

- The increase in interest rates and the economic slowdown have also been reflected in credit behavior, particularly consumer credit. As I mentioned earlier, this credit grew at rates close to 23% per annum in the third quarter of 2022. In the most recent period, it has drastically reduced its growth rate and credit balances in current Colombian pesos have stabilized at similar levels to those observed a year ago. The slowdown has been less, but also significant in housing and commercial loans, causing deteriorating impacts on the quality of the portfolio of credit institutions and forcing them to make significant increases in their provisions. This, of course, has reduced profits in the financial system, which in 2023 will be, on average, about half of what they were in 2022.
- Again, this is a painful situation that reflects an adjustment process that was necessary and that would probably have been more painful if it had been deferred in time and if the credit bubble that we saw in mid-2022 had continued to grow until it burst in a more traumatic way. Fortunately, this adjustment has taken place in such a way that the financial system's capital strength remains at very high levels, as reflected in solvency indicators well above the regulatory minimums.

Inflation and expectations

Turning to inflation results, the figures for October ratified the downward trend that we have been fortunately observing since April.

As I mentioned earlier, **total inflation now stands at 10.5%**, almost three percentage points below the 13.3% we had in March. On the other hand, core inflation has shown a reduction since July to 9.2% in October, after peaking at 10.5% in the second quarter of the year.

Despite the favorable trends exhibited in recent months by both headline and core inflation, it is clear that **Colombia is lagging behind other countries in the region such as Brazil, Mexico, Peru, or Chile, in the process of convergence of inflation towards the long-term target**. In these countries, inflation is already around 5.0% or below after having been at much higher levels, with countries such as Brazil and Chile even surpassing the maximum levels reached by Colombia. The sharp reduction observed in inflation has allowed them to move forward in a process of downward adjustment in their nominal interest rates. However, I should mention that when real policy interest rates are calculated by the difference between the nominal rate and observed inflation, they remain considerably higher in several of the countries mentioned than they currently are in Colombia. This illustrates once again that the problem we are having in Colombia today with such high nominal interest rates is not explained by excessive real rates, but by the very high levels of inflation, this being one more reason to persevere in the fight against inflation.

Although demand is already adjusting downward, Colombia's persistence of inflation at such high levels can be fundamentally explained by four factors that have made *Banco de la República*'s task particularly difficult:

- The increase in food prices. Although these prices exhibited absolute reductions in April and May, it is important to note that in the most recent months annual inflation continues to be driven up by this item, which in October still exhibited a 10.4% increase of vis-a-vis a year ago and over 40% with respect to two years ago. This illustrates that, despite the recent correction in food inflation, its relative prices are still at extraordinarily high levels and that the inflationary pressures on the market basket that accumulated on this matter were very strong, affecting the most vulnerable social sectors in a particularly critical manner, which are those that have a higher proportion of food in their market baskets.
- The items of the market basket corresponding to what we call "regulated prices" have increased particularly strongly in the most recent period, from 11.8% annual growth in December 2022 to more than 15% in all the months between April and October 2023. These increases are partly explained by the adjustments in the price of gasoline, which are indispensable for fiscal sustainability after a long period in which they were frozen (between 2021 and the third quarter of 2022), thus creating a large implicit debt for the Colombian Government. One lesson from the experience with gasoline prices is that it is not convenient to try to fight inflation by setting prices or tariffs that create sectoral distortions. This ultimately leads to adjustments having to be made at a later date. Something similar has been seen in the case of electricity fees, particularly on the Atlantic coast, whose

adjustments were deferred in the past and today must be stronger than they would have been in the absence of such deferrals.

- Third, the high inflation rates observed in 2021 and 2022 triggered indexation mechanisms that cause inflation to be more persistent. These indexation mechanisms are considerably stronger in Colombia than in other countries, possibly due to the perverse legacy of having had double-digit inflation levels in our country for nearly three decades at the end of the last century. These mechanisms include the annual adjustment in the minimum wage, which in the last two years has been considerably higher than observed inflation. They also include the adjustment mechanisms in the fees of many public utilities and the rule whereby current leases may be automatically adjusted based on the inflation observed in the previous year. All of these mechanisms may have their particular justifications, but they reduce the effectiveness of forward-looking inflation targeting and force monetary policy to be more restrictive than would otherwise be required for successful anti-inflationary policy.
- The fourth factor that helps explain the greater persistence of inflation in Colombia compared to other countries is the depreciation of the Colombian peso. Certainly, the exchange rate has undergone a strong downward adjustment over the last year, close to 20%, which will surely contribute to a smoother inflation reduction process. However, when compared to other countries in the region, the Colombian peso is one of the currencies that depreciated the most in 2021 and 2022. The appreciation observed since October 2022 can be interpreted as a late correction process of an excessive depreciation that the other countries did not experience in that magnitude.

The contrast between the strong depreciation of the Colombian peso in 2021 and 2022 and what happened in the main countries of the region with which we usually compare ourselves can be explained in part by the relative deterioration in the fiscal soundness of our country, which earned it the loss of investment grade by two credit rating agencies in 2021 and a deterioration in risk perception indicators with respect to our peers, such as Brazil, Mexico, Peru, or Chile. Colombia's relative position vis-à-vis these countries in terms of risk indicators has not recovered, but the excess depreciation of the Colombian peso has been significantly reversed since October 2022, which improves the likelihood that the persistence of high inflation can be broken and that we can advance in the process of convergence towards the 3.0% target in a reasonable term.

Analysts' expectations polled in the latest survey conducted by *Banco de la República* after the October inflation results were released exhibit inflation falling to **9.5% in December 2023 and to 5.3% in December 2024, and to just under 4.0% two years from now**. These expectations would imply the strongest reduction in inflation in the 100-year history of *Banco de la República* this year. However, it must be recognized that this reduction is somewhat more delayed than our target. We expect analysts and markets to continue to adjust their expectations downward in the coming months, as they did with the CPI results released last week.

In public discussions on the contractionary monetary policy adopted by *Banco de la República*, a dilemma is often raised between the search for lower inflation and the cost this generates in terms of economic growth. I sincerely believe, as I have said on many occasions and in different contexts, that this is a **false dilemma**. The choice we have is not between lowering inflation or growing more. On the contrary, lowering inflation is indispensable to bring interest rates back to low levels, which will stimulate investment, and to increase growth in the medium and long term, even if it means sacrificing some growth in the short term.

It should be noted that the policy interest rates set by *Banco de la República* are exclusively those corresponding to the overnight interbank market. Longer-term interest rates, both for TES (Bonds issued by the Colombian government and managed by *Banco de la República*) and for loans granted by banks to households and companies, are freely defined in the markets and depend critically on the expectations of the different agents on what they believe inflation-and therefore, policy interest rates-will be in the future. This implies that a fundamental element to keep the financing costs of the Government, companies, and mortgagors low is the credibility that *Banco de la República*will bring inflation to the target in a reasonably short term.

I dare to say that the Board of Directors of *Banco de la República* is fully aware of the benefits of lower interest rates in the Colombian economy vis-a-vis those we are observing today. However, that is not the discussion. What has deferred a reduction in the policy interest rate is the risk that a premature reduction in nominal interest rates may slow down the path of falling inflation and the chances of sustainably low interest rates. The dilemmas that this generates-with their costs, benefits, and risks-are carefully analyzed in each of the eight monetary policy decision sessions we hold annually. Of course, we will do so again in the next discussion on this topic, next December.

Fuente: https://www.banrep.gov.co/en/publications-research/speech-anif-radiography-colombian-economy