Blog <em lang="es">BanRep: The Inflation Target and its Importance for Price Stability

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Inflation is the generalized and sustained increase in the prices of goods and services. When inflation is high, money loses its value rapidly, which affects all sectors of the economy, especially households, as their purchasing power declines. This means that with the same amount of money, a household can buy fewer basic goods such as food, and access fewer services such as transportation and rent. Additionally, when inflation is not only high but also volatile, it hinders the financing of long-term projects that require a significant investment of resources such as education, entrepreneurship, and home purchases.

In Colombia, the 1991 Political Constitution assigned *Banco de la República* (the Central Bank of Colombia) the duty of “ensuring the preservation of the purchasing power of the Colombian peso, in coordination with overall economic policy.” To fulfill this legal duty, more than two decades ago, the Board of Directors of *Banco de la República* (BDBR) adopted an inflation-targeting framework, under which policy decisions regarding the policy interest rate aim to: 1) guide inflation toward a pre-established target that is positive but low, and 2) ensure that the economy grows and operates at a sustainable pace over time.

Since late 2009, *Banco de la República*’s annual inflation target has been set at 3.0%. This level is similar to inflation targets of other central banks, as shown in Infographic 1. Whenever this inflation target is achieved, the value of money is preserved in accordance with the constitutional mandate, and the risk of inflation turning negative is also reduced. Negative inflation is undesirable because, when prices fall, households and companies tend to postpone their consumption and investment decisions anticipating further declines, which in turn weakens economic growth and employment and makes debt payments more difficult.

Infographic 1. Inflation Targets for a Sample of Countries

The pre-established inflation target serves multiple purposes. First, comparing actual inflation with the target enables the Board of Directors of the Bank to determine the direction in which interest rate decisions should be oriented, ensuring that inflation does not persistently deviate either above or below its target. Second, as long as the target is publicly known, all economic agents can understand the Bank’s actions, anticipate them, and base their consumption, investment, pricing, and wage decisions on that target and the expected direction of monetary policy. Third, to the extent that the target is credible and companies use it as a guide when setting their prices, it becomes easier for the Bank to achieve its objective and for society to benefit from low and stable inflation. Finally, because monthly observed inflation can be compared to the 3.0% target, it becomes easier for the Bank to explain its decisions and be accountable to the public.

To achieve the inflation target, *Banco de la República*’s decisions regarding the policy interest rate are based on an analysis of the current situation and expected outlook of economic activity, as well as on the comparison between the 3.0% inflation target and both observed inflation and the inflation expected by economic agents. For example, if this analysis suggests that inflation and inflation expectations are persistently above the 3.0% target because economic spending (demand) exceeds the economy’s productive capacity (supply), the Bank’s policy interest rate is raised to bring inflation back to the target.

On the other hand, if price increases are caused by transitory factors, such as a short-term drought that temporarily elevates the prices of agricultural products, the policy interest rate may not be adjusted. However, in some cases, these temporary factors can cause more persistent inflationary pressures, thus leading inflation expectations across the economy to rise above the 3.0% target. In such situations, *Banco de la República* must raise the policy interest rate to reduce inflation expectations and help bring inflation back to the 3.0% target.

The inflation target is, therefore, the benchmark for *Banco de la República*'s analyses and policy decisions. Its consistency is essential for fulfilling the Bank's constitutional mandate and for its communication with the public.

Related Economic Concepts

- Inflation
  - It is the widespread and sustained increase in the prices of the goods and services most representative of household consumption in a country.
- Inflation Expectations
  - These are the estimates made by economic agents (households, businesses, investors, and experts) regarding the future level of inflation. If they believe that prices will rise by 3.0%, they adjust their decisions accordingly; that is, they negotiate wages, contracts, and prices based on this figure. This can drive future inflation to end up close to that 3.0%, acting as a self-fulfilling prophecy.
- Inflation Target
  - Within an inflation-targeting framework, it is the objective set by the Central Bank to keep inflation low and stable. In Colombia, the target is 3.0%. The target serves to guide expectations and economic decisions, aiming for stability and sustainable growth. Monetary policy is designed to achieve this target.
- Policy Interest Rate
  - It is the interest rate at which *Banco de la República* lends to or borrows from financial institutions, generally for a one-day term. This rate is *Banco de la República*'s main policy instrument.

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Related Questions and Answers

What is the inflation target and why is it set?

The inflation target is the quantitative objective set by Banco de la República to fulfill its constitutional mandate of preserving the purchasing power of money through low and stable inflation. The Bank sets a target to keep inflation close to that level and to guide its decisions regarding the policy interest rate. It is also set so that the public is aware of it, can anticipate the Bank's actions, and make consumption, investment, pricing, and wage decisions consistent with this target. Additionally, by having a pre-established target, the Bank can compare it with observed inflation at any given time and explain its decisions to the public.

What happens when inflation is high and volatile?

When inflation is high, money quickly loses its value; this means that a household can buy fewer basic goods such as food with the same amount of money. When inflation is both high and volatile, it becomes difficult to finance long-term projects, such as those required to expand companies' productive capacity or to purchase a house.

How is the inflation target achieved?

The Bank compares both observed and expected inflation with the target and assesses the current and projected state of economic activity. If inflation (observed or expected) is above the target because economic spending exceeds productive capacity, the Bank must raise the policy interest rate so that inflation returns to the target. Inflation can also exceed the target due to factors that, although transitory, such as a drought, cause more persistent price pressures. In this case, the Bank must also increase the policy interest rate to bring inflation back to the target.

What is the inflation target in Colombia? When was it set at that level, and how does it compare with other countries?

Colombia's inflation target is 3.0%. It has been set at this level since 2009 and it is the same in countries such as Chile, Mexico, Brazil, Costa Rica, China, Hungary, the Philippines, and Georgia. It is also very close to the targets of Australia, Indonesia, Iceland, Malaysia, Poland, and Romania, which set it at 2.5%, as well as India, Paraguay, and Russia, at 4.0%.

What does the inflation-targeting framework mean?

An inflation-targeting framework means that *Banco de la República* makes decisions regarding the policy interest rate to ensure that inflation approaches the target and the economy operates at a sustainable pace over time.