MONETARY POLICY IN COLOMBIA: FUNDAMENTALS, STRENGTHS AND DILEMMAS*

Medley Global Advisors

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***Personal Opinions**

The independence of the Central Bank of Colombia

- The CB was granted independence from the Government in 1991. The Board is made up of five full-time members, plus the Minister of Finance and the Governor.

- Following our Constitutional mandate, "the primary goal of monetary policy is price stability, in coordination with the objectives of general economic policy."

- Since 1999, the CB has used a flexible Inflation Targeting strategy to handle monetary policy. The policy objectives of this strategy are: (i) maintaining a low and stable inflation (3.0% +/- 1.0%); (ii) smoothing output fluctuations around a sustainable growth path; and (iii) contributing to financial stability.

The main instrument and rule for monetary policy

- The CB's main instrument for monetary policy is the short-term interest rate. When aggregate demand falls below its sustainable level and the economy faces lower inflation, the (anticipatory) appropriate policy reaction is to lower the interest rate.

- In contrast, once the economy recovers its growth pace and faces future inflationary risk, the (anticipatory) appropriate policy reaction is to increase the interest rate.

The keys for a successful monetary policy

- Anticipation: forward looking
- Counter-cyclicality: leaning against the wind
- Communication: inclusive transparency

Exchange rate floating regime (1)

- In a commodity-exporting, small, open economy with price/wage rigidities such as Colombia, most shocks are better absorbed by a flexible exchange rate regime. By contrast, peg regimes force output and employment to absorb the adjustment to the shocks.

- Exchange rate flexibility eases the adoption of a *counter-cyclical* monetary policy response to the shocks, since there is neither a commitment nor a need to defend the exchange rate.

Exchange rate floating regime (2)

- Exchange rate flexibility is feasible in the absence of large currency mismatches or high pass-through from the exchange rate to domestic prices.
- Currency mismatches are restrained by means of adequate regulation and by the flexibility of the exchange rate itself. The latter ensures that agents internalize currency risk in their decisions regarding the composition of their balance-sheets.
- Pass-through is limited by anchoring inflation expectations and the credibility of monetary policy.

The 3-‘pillars’ of the Colombian macroeconomic policy framework

- Monetary policy based on Inflation targeting and exchange rate flexibility: the CB's role.
- Fiscal policy based on ‘the medium term fiscal framework’ and a Fiscal Rule: Ministry of Finance's role.
- Macro-prudential supervision and regulation to preserve financial stability: this role is shared with other state agencies (Ministry of Finance, Office of the Financial Superintendent, and the Deposit Guarantee Fund).

Recent economic performance as a driver of monetary policy.

- Between 2005 and 2014, the Colombian economy performed relatively well compared to the region.
- Average GDP growth during that decade was 4.7%, close to its potential.
- The strength of the Colombian economy contrasted with slow growth in other economies of the region and the rest of the emerging world.

2016: dilemma triggered by the fall of oil prices, and its impact on income and the weakening of the currency.

- The CB now faces a dilemma: while the economy is decelerating and below potential GDP, inflation has been steadily going up (8.2%), and has remained above the upper limit of the target during the last sixteen months.

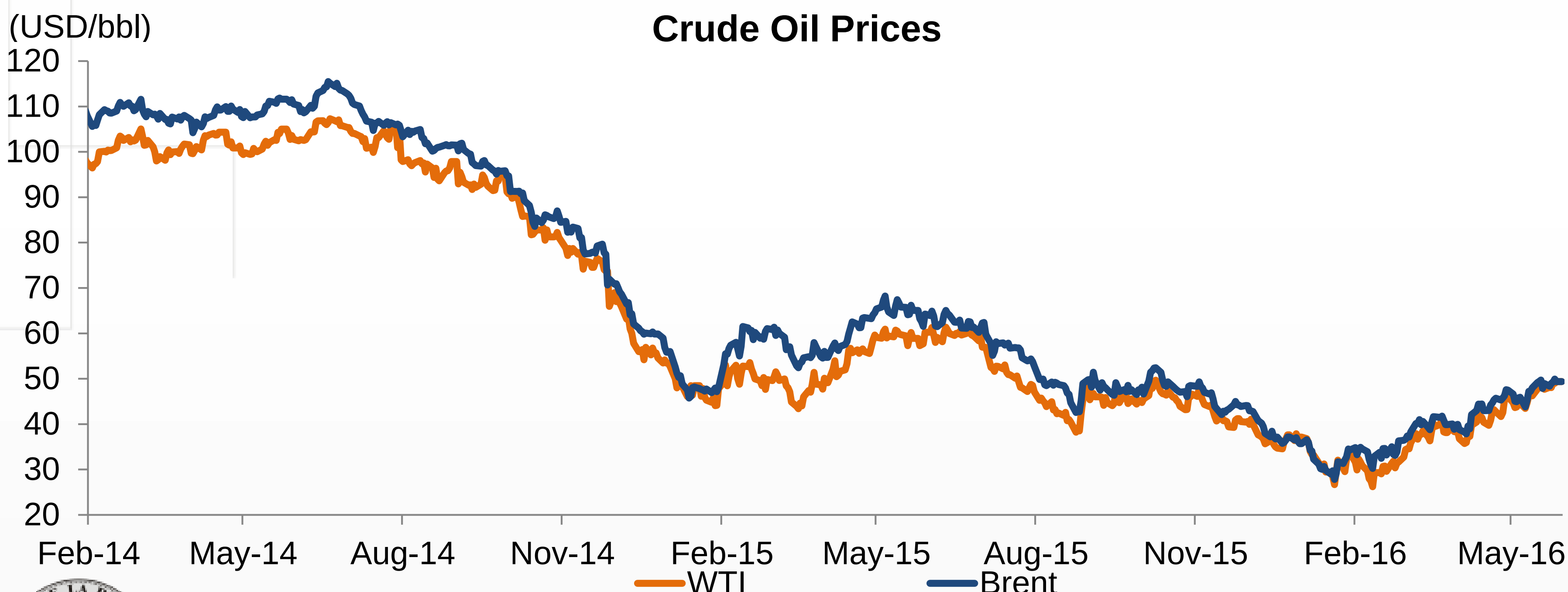
- The problem is no longer originated in food inflation. Even excluding food, inflation has surpassed the upper limit of the target and continued ascending during 18 months till March. ‘Core’ inflation is also above the upper limit, but in May for first time after the previous nineteen consecutive months did not go up further. Meanwhile, the CB’s real policy interest rate has been expansionary.

GDP and inflation performance (in annual %) of Colombia and partners in LatAm. In GDP growth, Peru and Colombia are ahead; in inflation and expectations, Brazil and Colombia are lagging (excluding Venezuela).

Country	GDP growth 2015	GDP growth 2016 (p)	GDP growth PIB 2017 (p)	Current actual inflation	Expect. for 2016 Bloomberg May 27th
Brazil	- 3.8	- 3.6*	0.7	9.3	8.5
Colombia	3.1	2.5**	2.7	8.2	7.0
Chile	2.1	1.8	2.5	4.2	4.0
Ecuador	- 0.5	- 2.5	- 2.0	2.6	2.9 (CB)
Mexico	2.5	2.4	2.8	2.5	2.9
Peru	3.3	3.5	4.0	3.9	3.6
Venezuela	- 10.0	- 7.0	- 4.0	181 (Gob)	720 (FMI)

Source: Central Banks, FMI, and Bloomberg. *Contracted 5.4% first quarter. **Grew 2.5% first quarter.

The end of the 'bonanza'. The collapse of oil prices seriously hurt the national government's finances. In 2013, 20% of total government revenues came from the oil industry, equivalent to 3.3% of GDP. In 2016, that source disappeared. By the end of this year the fiscal deficit could reach 4.0% of GDP.



Source: Datastream

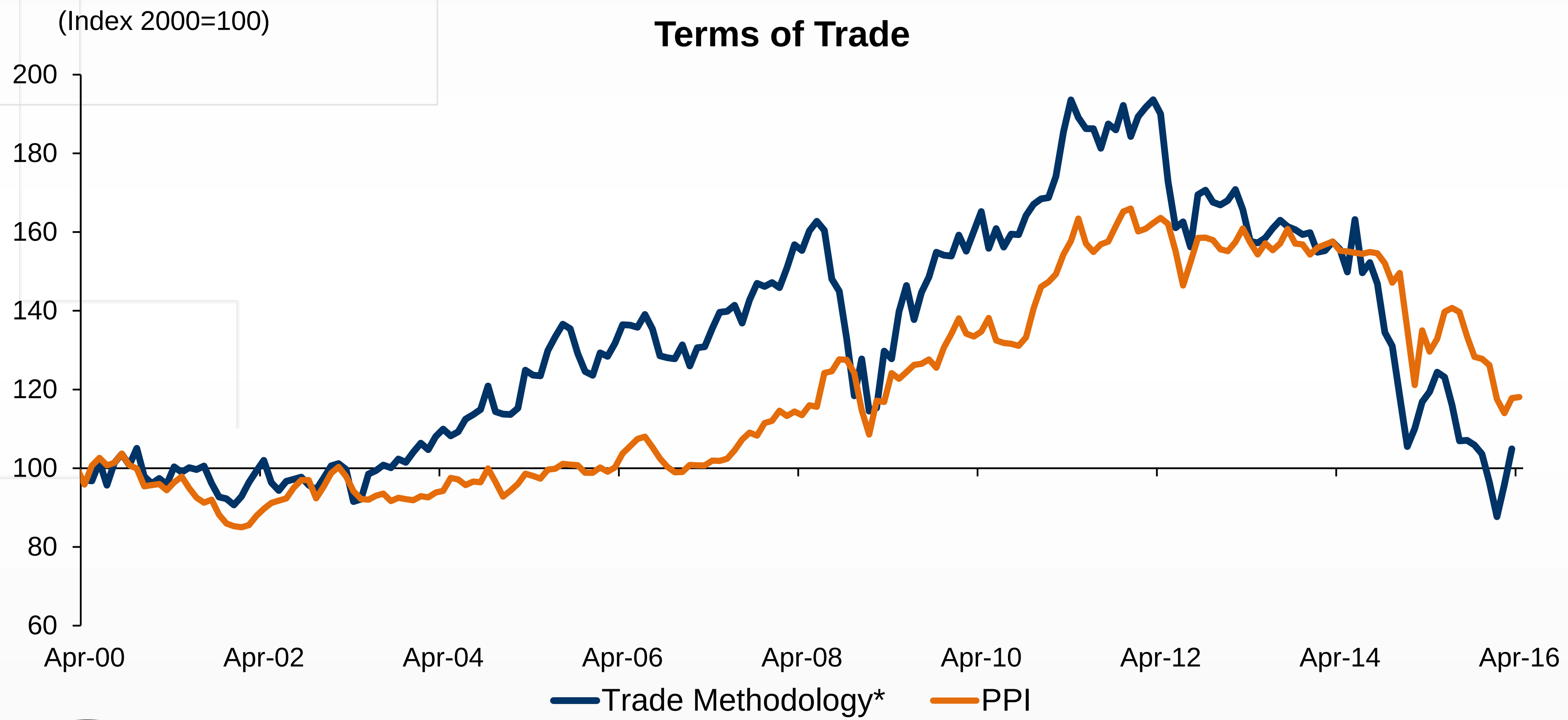
According to Fedesarrollo, even reducing public expenses and investment substantially, it would not be possible to meet the Fiscal Rule under an scenario of no structural fiscal reform.
By 2020, the deficit would reach 5.5% of GDP, versus a legal maximum limit of 1.4%.

Balance fiscal del GNC

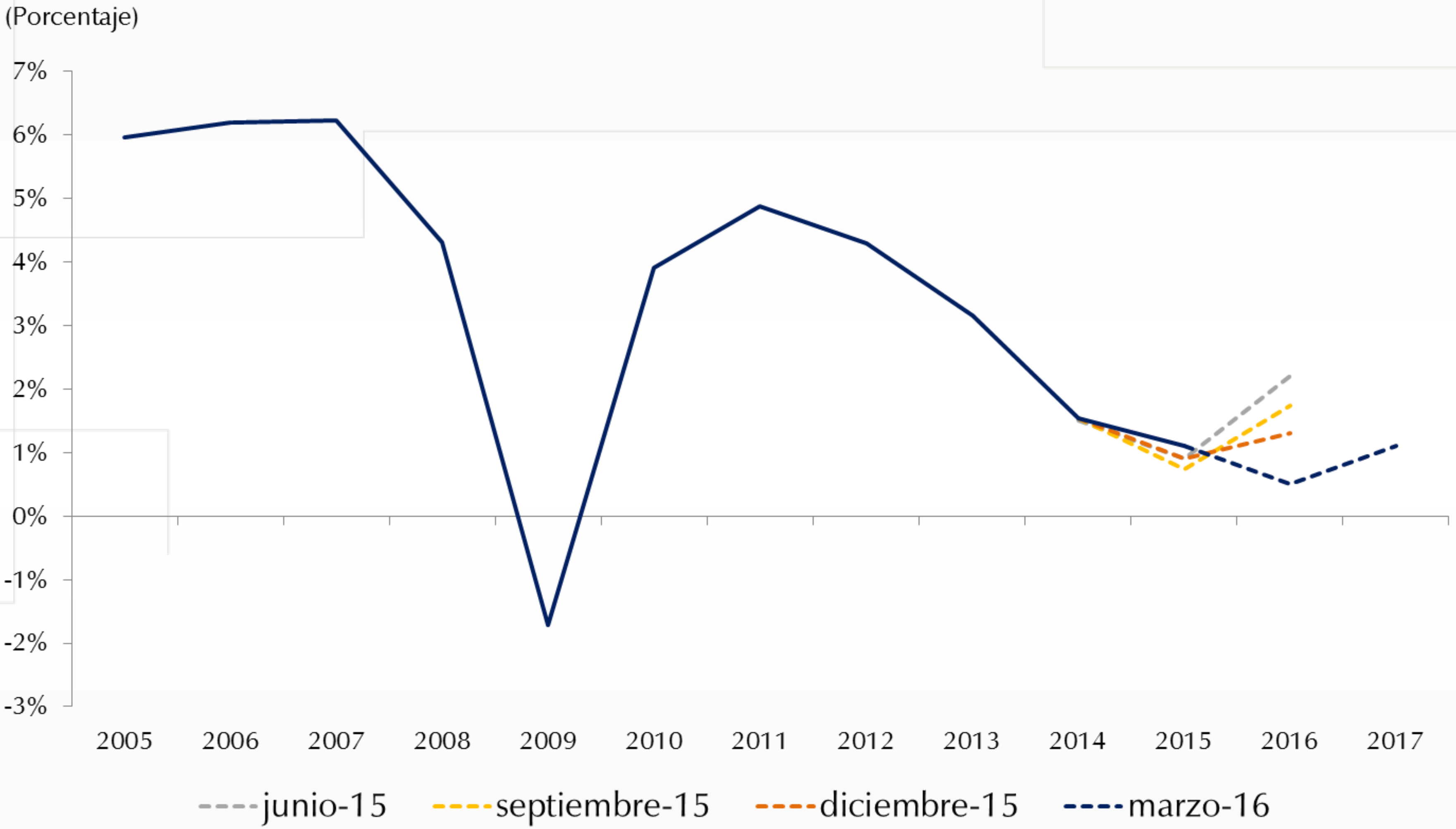
	2014	2015	2016	2017	2018	2019	2020
Ingresos totales	**16.7**	**16.1**	**14.9**	**14.2**	**14.0**	**13.3**	**13.2**
Renta petrolera	2.6	1.2	0.1	0.0	0.1	0.2	0.3
Tributarios no petroleros	13.1	13.8	13.9	13.6	13.3	12.4	12.3
Otros ingresos*	0.9	1.2	0.8	0.6	0.6	0.7	0.6
Gastos totales	**19.1**	**19.1**	**18.9**	**19.2**	**18.9**	**18.6**	**18.7**
Inversión	3.0	2.7	1.9	1.8	1.8	1.9	1.9
Intereses	2.2	2.6	3.0	3.1	3.3	3.4	3.6
Funcionamiento	13.9	13.8	14.0	14.3	13.8	13.3	13.3
Déficit total	**2.4**	**3.0**	**4.0**	**5.0**	**4.9**	**5.3**	**5.5**
Deficit estructural Regla Fiscal	**2.3**	**2.2**	**2.1**	**2.0**	**1.9**	**1.6**	**1.4**

Nota: Cifras a diciembre de 2015.
Fuente: Ministerio de Hacienda y Crédito Público, proyecciones Fedesarrollo.

Negative shock to the terms of trade. Deep imbalances that require adjusting the total expenditure of the economy. The fall (9.0% in 2014 and 24.0% in 2015) contracted national income.

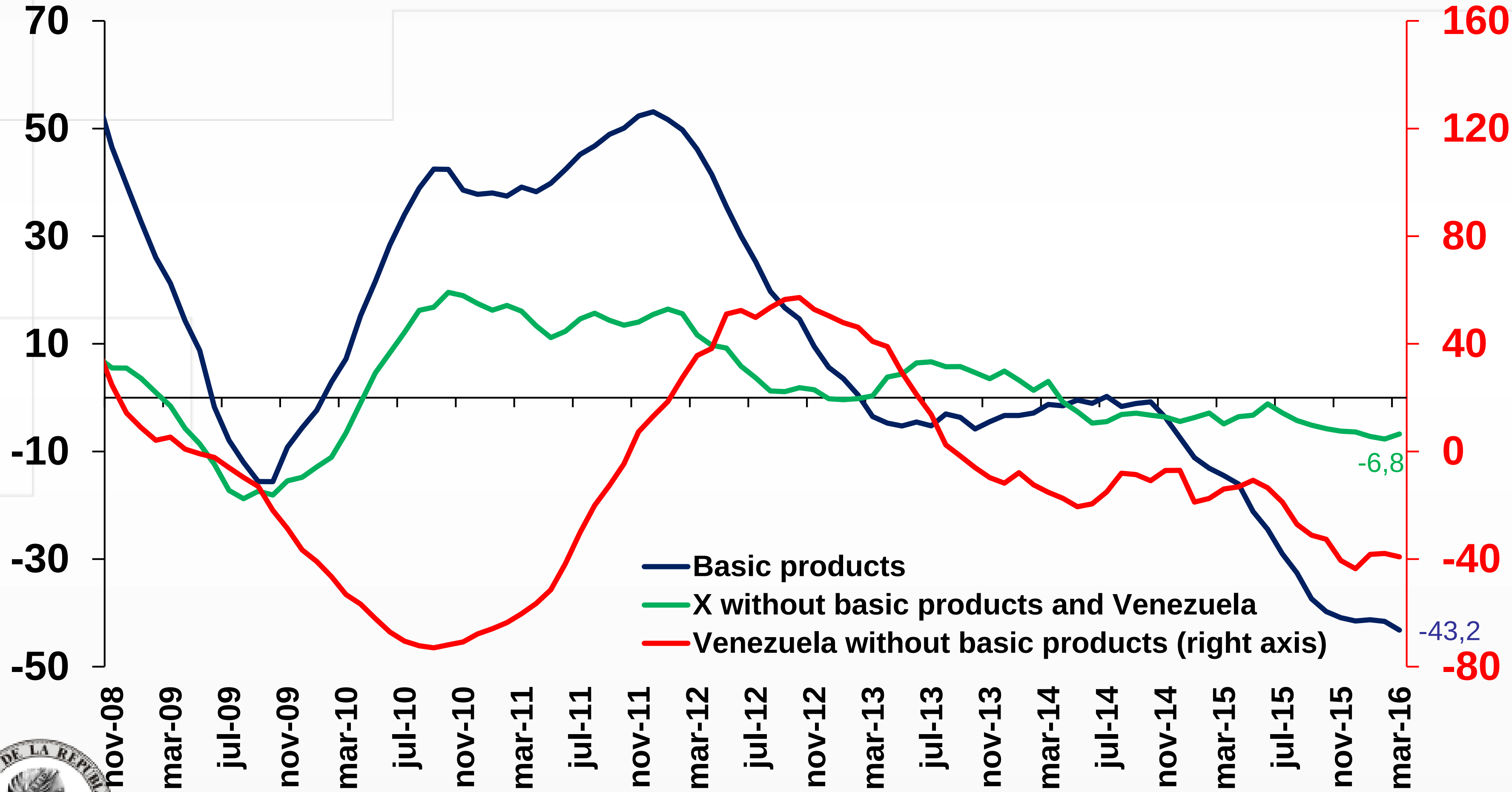


Estimated Growth of Trade Partners

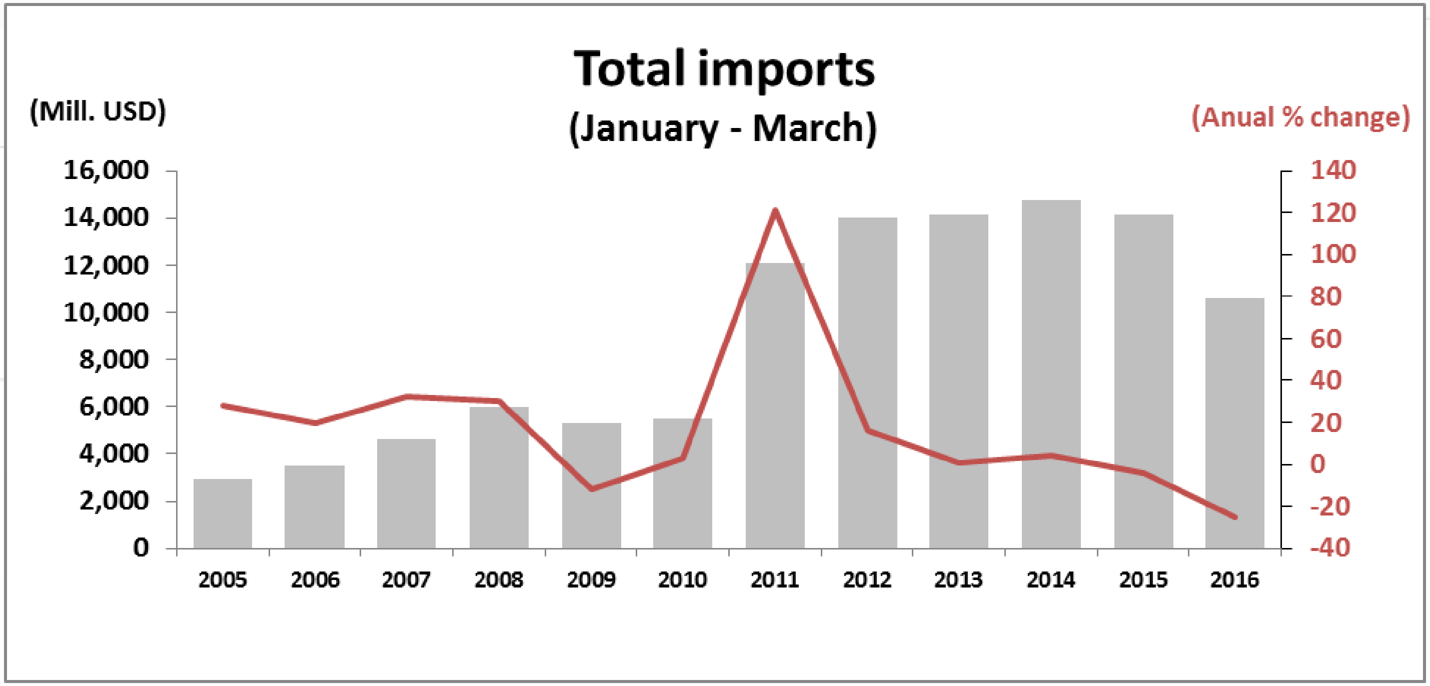


Source: Banco de la República

Exports (USD) Growth (12-month aggregate %). All categories in negative terrain: first quarter of 2016 vs same period 2015: -32%



Imports (USD) Growth (12-month aggregate %): also falling (-25%), but less than exports.

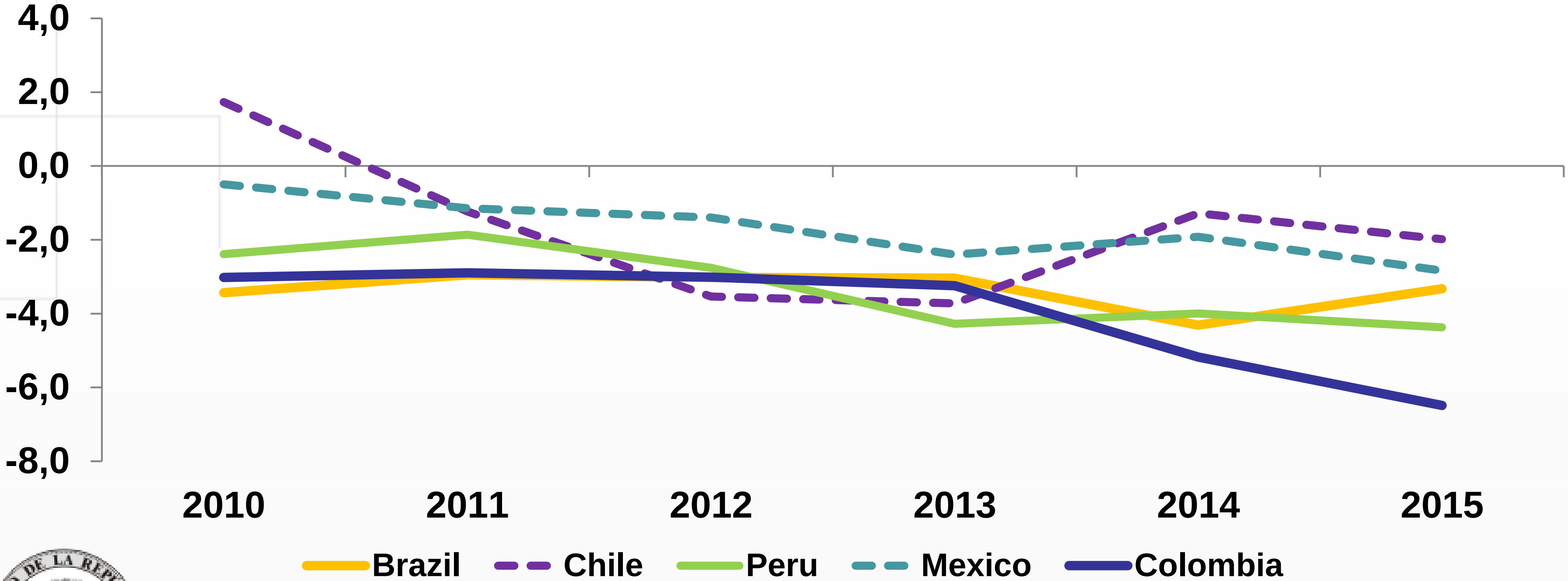


Jan-Mar 2015 = US$ 14.113 m - Annual var. % = -4,4%

Jan-Mar 2016 = US$ 10.576 m - Annual var. % = -25,1%

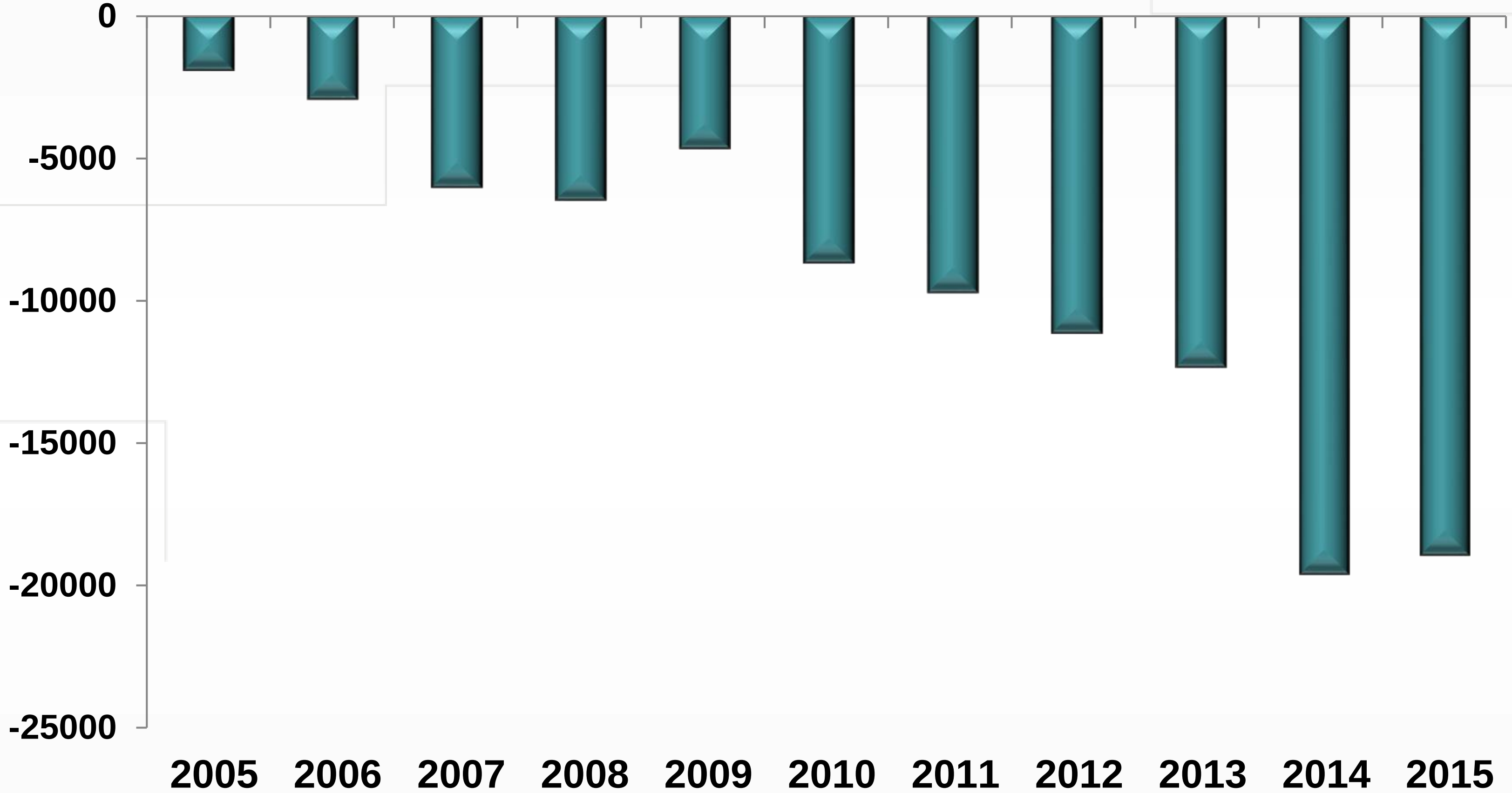
Source: DANE.

As a result, the Current Account deficit (% of GDP) reached 6.5% by December 2015, the highest among economies of similar size to Colombia's, or bigger.
The twin deficits (fiscal and current account) represent the economy's Achilles heel.



Source: Datastream, IMF.

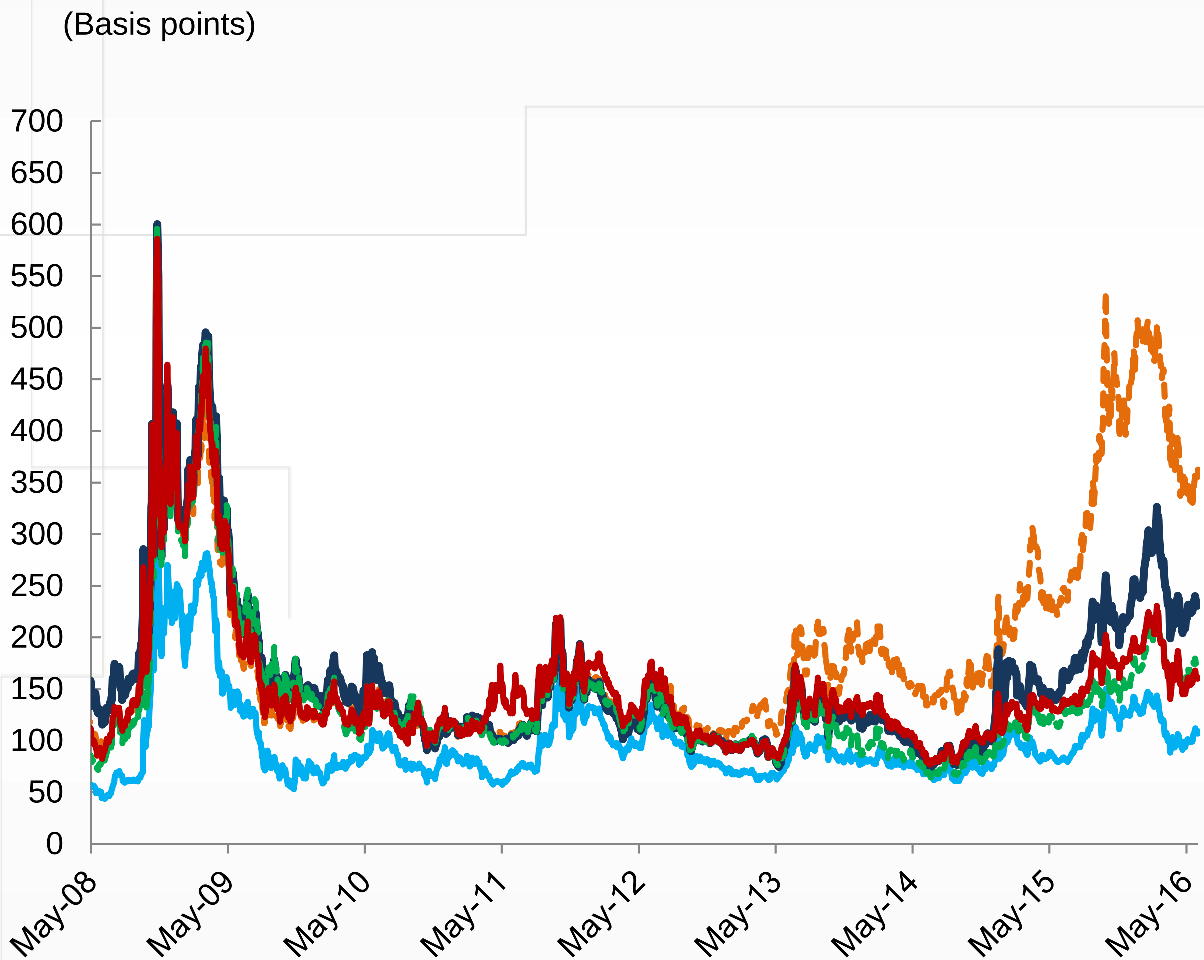
Current Account Balance (USD Mll)

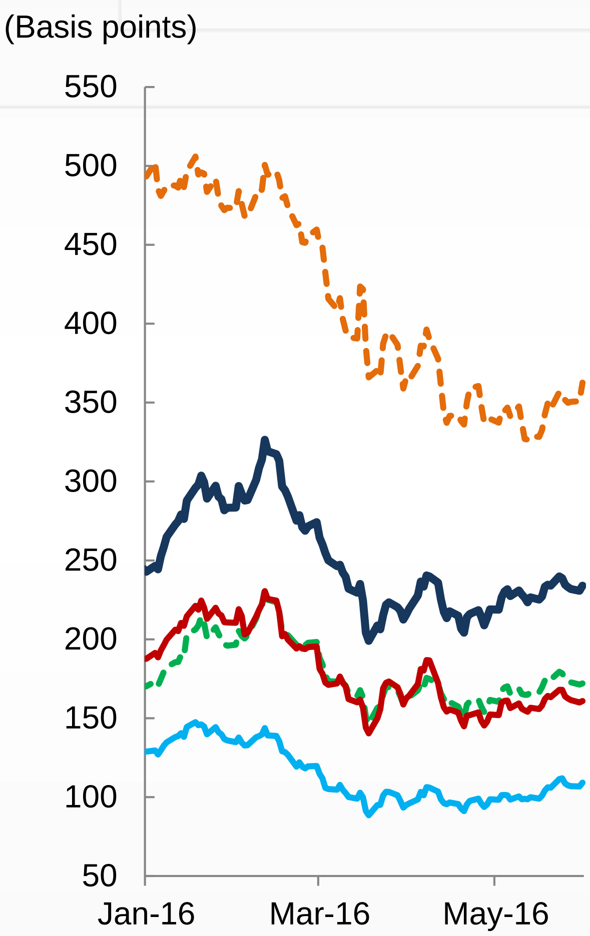


Source: Banco de la República

Risk Premia indexes (CDS's) in LatAm

5Y Credit Default Swaps





Brazil Chile Colombia Mexico Peru

Fuente: Bloomberg

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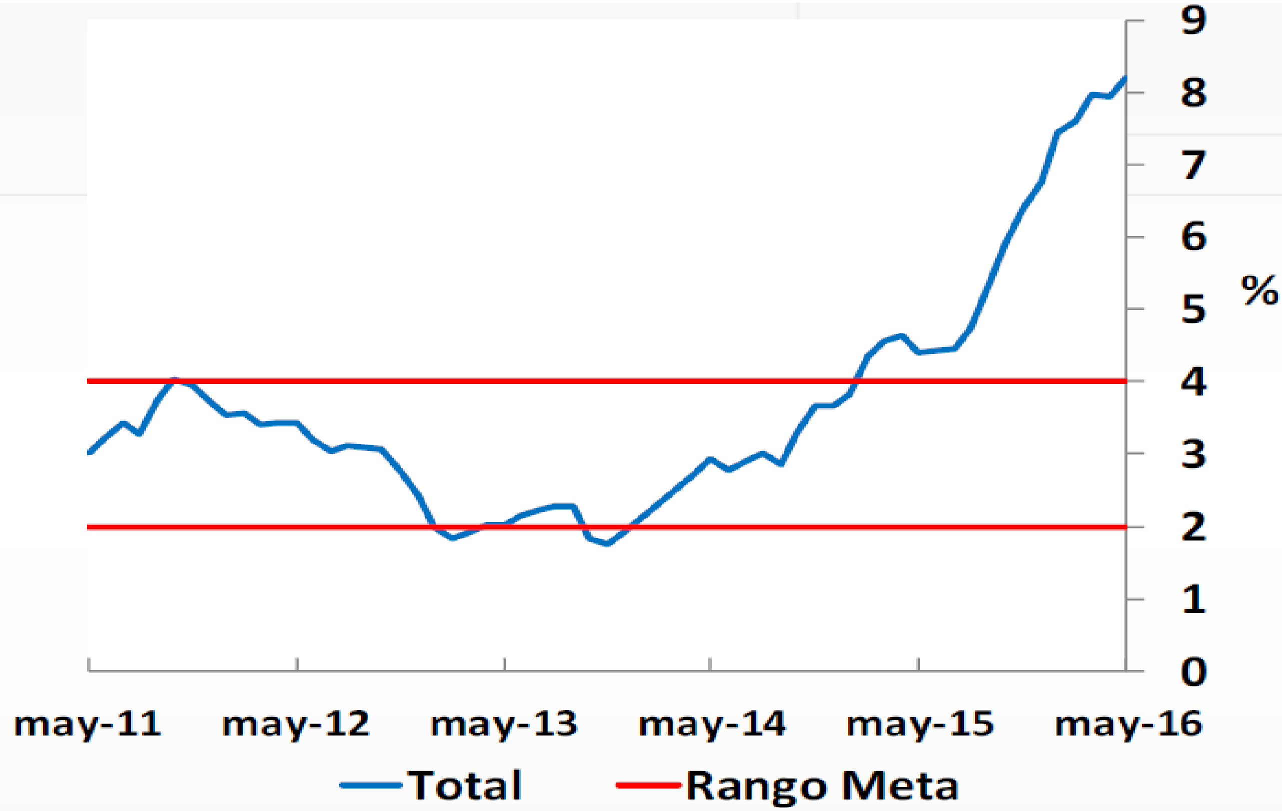
LATAM	day	week	month	current year	6 months	one year	two years	three years
Colombia Average Exchange Rate at 13:00:00	-2,30%	-4,51%	-0,25%	-7,05%	-10,16%	13,16%	56,49%	55,95%
Colombia Last Rate at 13:00:00	-2,57%	-4,78%	-0,52%	-7,31%	-10,41%	12,85%	56,06%	55,52%
Brasil	-1,11%	-4,45%	-1,87%	-12,88%	-8,04%	9,81%	53,55%	55,87%
México	-1,28%	-0,21%	1,24%	7,10%	7,99%	17,30%	42,54%	39,37%
Argentina	0,27%	-1,19%	-2,90%	6,88%	41,97%	53,33%	70,01%	158,64%
Peru	-0,29%	-2,26%	-1,01%	-3,33%	-2,19%	4,64%	18,54%	18,47%
Uruguay	-0,16%	0,00%	-2,72%	2,96%	3,93%	15,14%	33,74%	47,51%
Chile	-0,14%	-1,83%	0,49%	-4,23%	-3,57%	6,56%	23,45%	33,75%

Currencies Depreciation (green)
Currencies Appreciation (yellow)

Annual inflation to May: 8.2%. It is the highest level in the last fifteen years and has remained above the upper limit of the target range (3.0% +/- 1.0%) during the last 16 sixteen months.

Consumer Price Index

may-16	8.20%
abr-16	7.93%
mar-16	7.98%
feb-16	7.59%
ene-16	7.45%



Food inflation (13.5%) -pushed by climate conditions such as *El Niño*- has been leading total inflation. As it represents a typical supply shock, in principle, monetary policy should not react unless inflation expectations become affected, as has been the case.

Food Inflation

may-16	13.46%
abr-16	12.63%
mar-16	12.35%
feb-16	11.86%
ene-16	12.26%

Even excluding food, inflation reached 6.1%.

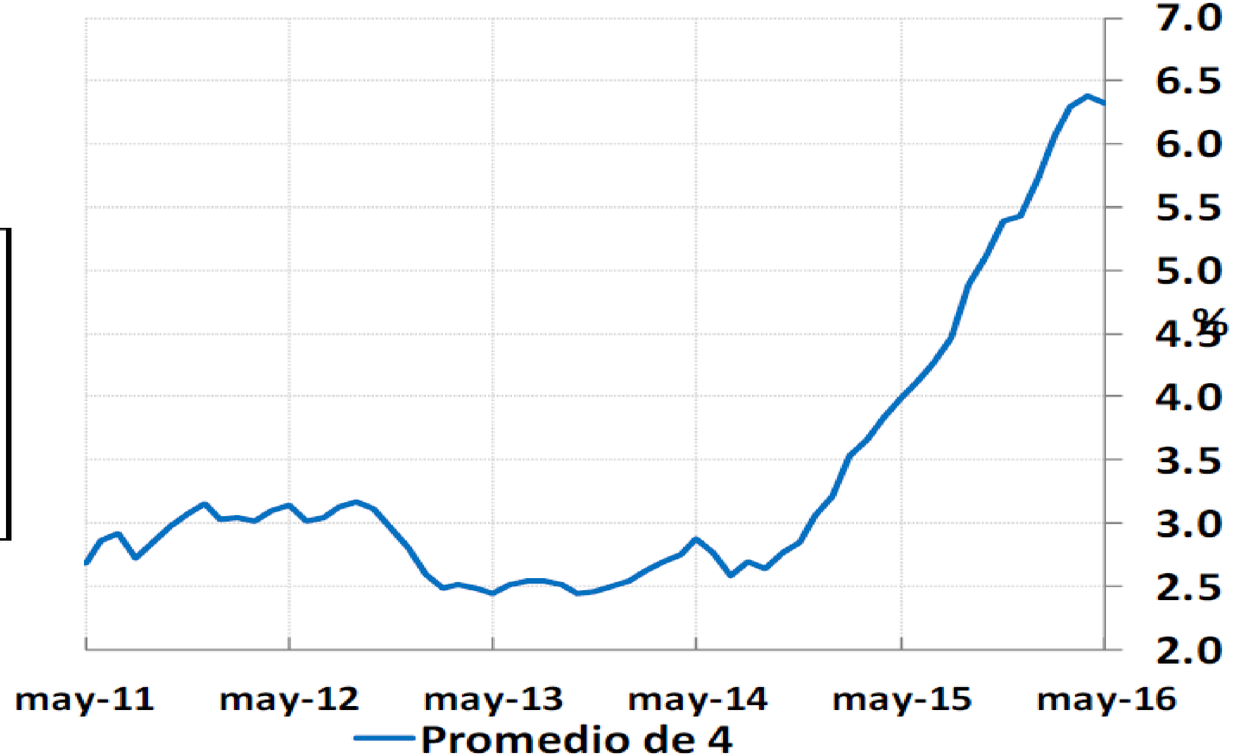
Inflation excluding Food

may-16	6.07%
abr-16	6.02%
mar-16	6.20%
feb-16	5.88%
ene-16	5.54%

Core inflation: 6.3%. In May, for first time after the previous nineteen consecutive months did not go up further.

Core Inflation Indicators

may-16	6.33%
abr-16	6.38%
mar-16	6.29%
feb-16	6.07%
ene-16	5.73%



Fuente: DANE. Cálculos del Banco de la República.

All relevant inflation indicators are going up. It is not only a question of the persistence of inflation, but of the persistence of the surge of inflation: symptoms of inflationary demand pressures.

(Data in % annual terms at the end of May of each year)

Type of inflation	2014	2015	2016
CPI	2.9	4.4	8.2
Excluding food	2.8	3.7	6.1
Excluding food and utilities	2.9	3.8	6.1
Non tradables	4.1	4.2	8.0
Non tradables excluding food and utilities	3.7	3.8	4.8
Core	2.9	4.0	6.3

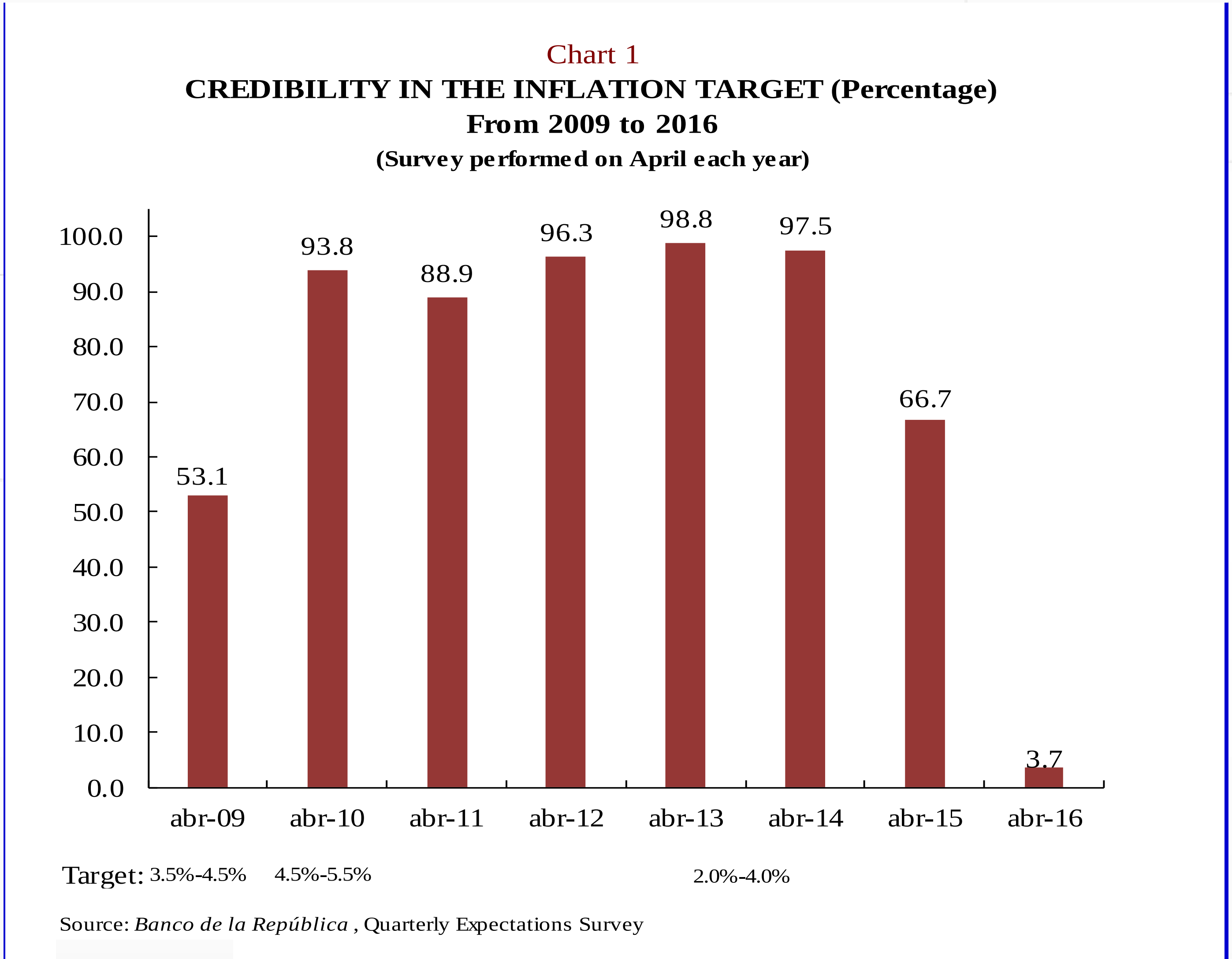
How should the monetary authority respond?

- The dilemma should be solved depending on the behavior of inflation expectations, the key measure of the credibility in the monetary policy.
- Most main indicators show expectations above the target.

“*Not only do expectations about policy matter, but, at least under current conditions, very little else matters*.”

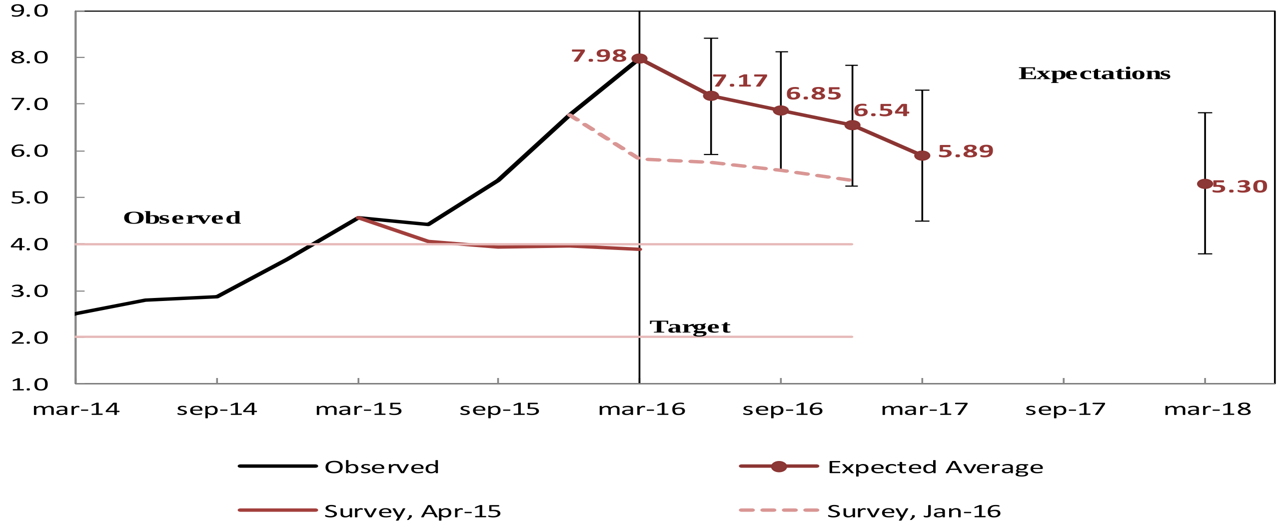
(Michael Woodford)

Credibility in inflation targets 2009-2016



Inflation expectations: unanchored with respect to the target. Comparison between BR polls in April 2015, January 2016, and April 2016. According to the most recent CB poll, inflation expectation for December 2016 is 6.0%. According to Bloomberg, 7.0%.

Chart 2
OBSERVED INFLATION AND INFLATION EXPECTATIONS
(To three, six, nine, twelve and twenty-four months)
(Yearly inflation)



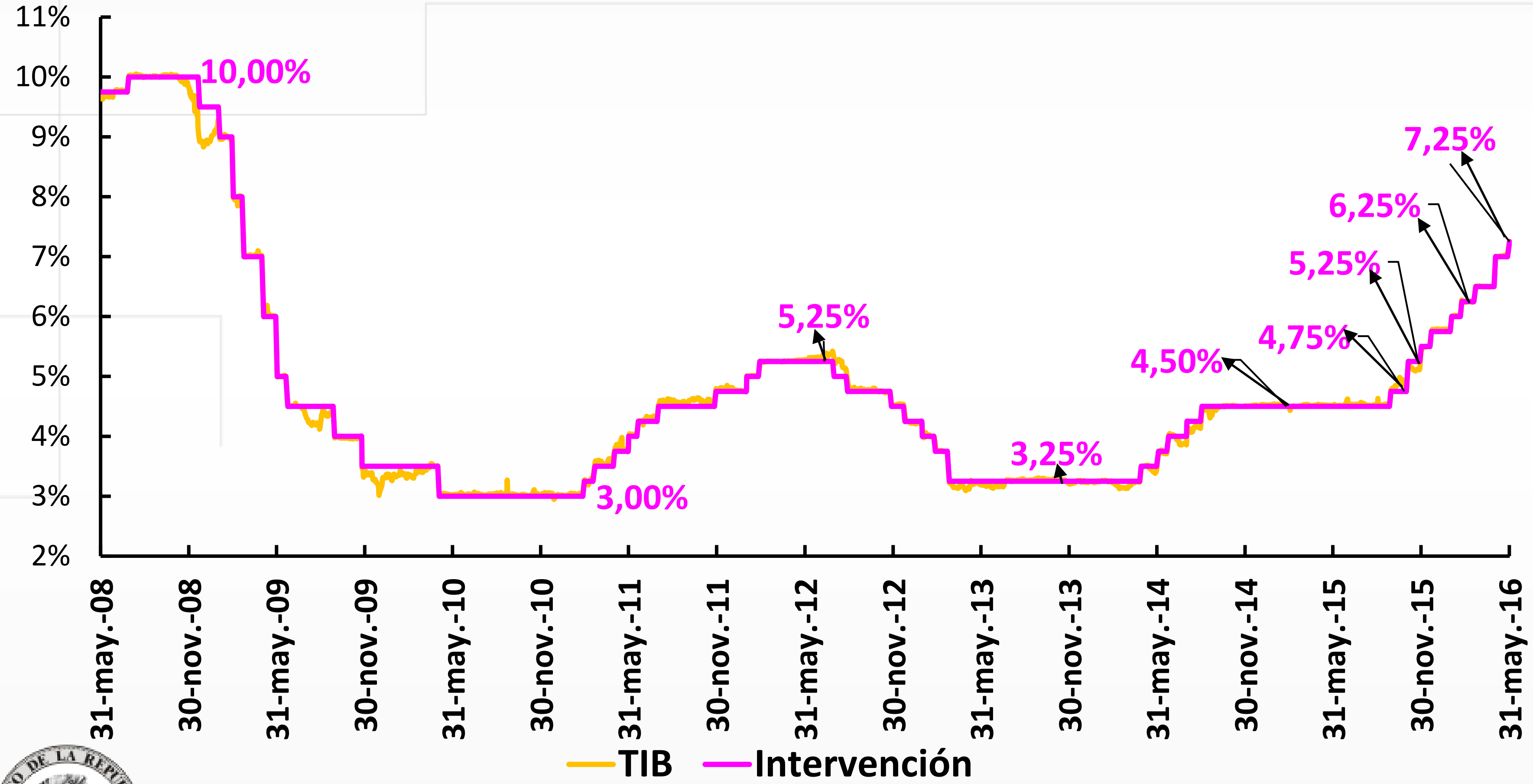
*The corresponding standard deviation is presented around every expectation.

Source: *Banco de la República* , Quarterly Expectations Survey DANE

Policy Response

The Board of Directors has raised the policy interest rate 275 basic points from September last year until April 2016: from 4.50% to 7.25%.

Monetary policy path since 2008



The monetary policy 'stress test'

- The real interest rate, adjusted by inflation, has been close to zero during the last year.
- The real neutral rate is around 2.0%.
- The result: monetary policy continues to be expansionary, facing an inflation rate that doubles the upper limit of the target range and inflation expectations unanchored from it.

Conclusions

- It is unlikely that the current monetary policy stance is sufficient to ensure that inflation and its expectations converge and return to the target before the end of 2017.
- In case that happens, 2017 would be the third consecutive annual failure in meeting the target.
- Monetary policy should also contribute to reduce the current account deficit.

Thank you.