Presentation, summary and conclusions

Monetary-policy strategy

✠ On October 13, 2000 the Board of Directors of the Banco de la República revised the strategy for conducting monetary policy. The Board introduced a number of changes in the parameters of the major variables used in monetary-policy decision-making and deemed it appropriate to make a public statement specifying the criteria guiding the decision-making process.

✠ The aim of monetary policy will continue to be attainment of inflation rates consistent with the constitutional mandate of ensuring price stability, in coordination with an overall macrocoeconomic policy designed to stimulate growth in output and employment. This aim is expected to be achieved by defining gradually decreasing inflation targets.

✠ To this end, the Board has to date drawn up a monetary program by defining a monetary-base path considered consistent with attaining present and future inflation targets, and with the rest of the government's macroeconomic program. The Board has regularly analyzed the monetary and inflation situation on the following basis:

- Monitoring the behavior of the monetary bases's 20-month daily moving average relative to a +/- 3.0% corridor around the initially defined path.

- Identifying significant changes in the level and composition of the monetary base.

- Evaluating a set of indicators and forecasts of inflation and economic activity.

✠ On the basis of this analysis, decisions have been taken on making changes considered necessary in monetary-policy stance. An explanation of these decisions, together with a description of the analysis process and presentation of relevant analysis data, has been published in quarterly inflation reports, the Board's reports to Congress, and in monthly press releases.

✠ It should be pointed out that the Board's decisions on monetary-policy stance have not responded mechanically or exclusively to deviations of the monetary-base average from its corridor. In fact, in recent months the Board has allowed such deviations because it has identified changes in the monetary base's velocity of circulation that call for greater growth of the base, without jeopardizing attainment of the inflation targets. These changes are connected with the impact of the financial-transaction levy on the public's demand for cash and current accounts, as mentioned in the July Report to Congress and in previous press releases.

Moreover, inflation projections, and indicators of real activity have suggested that recent monetary- policy stance was compatible with the inflation target.

✠ The Board has revised its monetary strategy in order, first, to make its decision-making on policy clear to the public, by pointing out that evaluating the indicators and forecasts of inflation and other economic variables is as important as monitoring the monetary-base's behavior with respect to its reference path. In this way, advance is made in incorporating the elements of an Objective Inflation scheme into the Board's monetary strategy. Second, the revision introduces some changes in the level and moving average of the monetary-base's reference path.

✠ The main elements of the monetary-policy strategy defined by the Bank are described below:

✠ Decisions will continue to be made on the basis of the following elements:

- Setting an inflation target;
- Assessing the general status of the economy, inflation trends and outlook, and the unemployment situation; and
- Monitoring the behavior of the money supply with respect to reference values previously defined to be conducive to meeting the inflation target.

✠ To guide the formation of inflation expectations, bearing in mind the lagged effect of monetary policy on prices, the Board will set multiannual inflation targets. It now confirms the targets for 2001 and 2002, set at 8.0% and 6.0% respectively.

✠ In its internal decision-making the Board shall continue to make a detailed monthly evaluation of inflationary pressures and the outlook for inflation. The evaluation will be based on a report by the Bank's technical team. A quarterly Inflation Report shall continue to be published to let markets know how the Board perceives the chances of meeting the inflation target and enable them to assess how consistent the Board's action is with the technical analysis. If the Board's evaluation suggests that under prevailing monetary-policy conditions inflation in the current or following year will deviate from the target, the Board shall modify its policy stance.

✠ The behavior of money, particularly the monetary base and its composition, plays an important part in the Board's decision-making. A reference value shall therefore be set for the monetary base and built in such a way as to be compatible with the inflation target, projected real-GDP growth, and predictable changes in the velocity of circulation. The Board shall evaluate inflationary pressures and analyze the monetary base's behavior with respect to its reference value. Under normal conditions, significant deviations of the monetary base from its reference value point to risks of not meeting the inflation targets.

✠ As in the past, the setting of a reference value for the monetary base does not mean that the Bank will automatically correct any short-term deviation of the monetary base from this value. Bearing in mind the increased demand for cash and checking accounts, the Board has for some weeks considered that the monetary base's reference line for the rest of 2000 should be about 7.0% above the midpoint of monetary-base corridor defined at the end of last year. Should the monetary base deviate significantly for several weeks from the reference values, the Board shall either take policy measures or publicly explain why it will not do so. The latter case may occur where inflation and other economic-variable indicators and forecasts provide strong evidence about meeting the inflation targets. For easy monitoring of the monetary base relative to the reference line, the Bank shall publish weekly figures of the actual base, its 45- and 20-day moving averages, and the reference value. The Board shall routinely revise the monetary base's reference values and may modify them if there are solid technical reasons for doing so, provided attainment of the inflation targets will not be jeopardized.

✠ The strategy changes are intended to make the Board's decision-making more transparent and monetary policy more readily understandable.

Assessment of inflation in september 2000

✠ On October 13, 2000 the Board of Directors also analyzed how inflation stood in September. The main findings are as follows:

✠ In September the annual change in the Consumer Price Index (CPI) was 9.2%, down by 0.5 percentage points on June and by 0.l percentage points on a year earlier. This was the smallest CPI growth for any September since 1971, and made this the 17th month in a row with inflation equal to or under 10.0%

✠ For the year to September consumer inflation was 7.7%, down by 0.1 percentage points on the same period in 1999. The items most responsible for third-quarter inflation--accounting for about 62.0% of it-- were vehicles, water supply, sewerage and waste collection, taxi fares, and fuel. As in the first half of the year, the greatest upward pressure on third-quarter prices came from higher gasoline prices, devaluation, and the dismantling of utilities subsidies. Third-quarter food prices, in contrast to their behavior over much of the first half, stopped pushing inflation up and in fact helped to reduce it with negative or zero monthly variations.

✠ The 12-month price growth was above average for transport (17.2%), diverse expenditures (15.0%), health care (10.0%), and education (9.4%). It was below average for clothing (2.9%), housing (5.8%), and food (8.2%).

✠ Under the alternate classification (tradables and nontradables), the most notable development was a drop in the nontradables' annual price variation, from 10.4% in June to 9.6% in September. This drop came mostly from a slower price change (13.3% as against 25.5%) in flexible goods (root crops, fruits and vegetables), caused by an abundant supply of farm produce over the third quarter. For tradables, the annual price variation edged up from 9.4% in June to 9.9% in September, showing the effect of devaluation on consumer prices.

✠ Core inflation, measured as the average of annual growth in four indicators determined by the Bank, ran at 8.5% at the end of the third quarter, down by 0.5 percentage points on June, owing to slower growth in the trimmed mean and the asymmetric mean. The inflation nucleus increased slightly, while the CPI excluding food remained stable. If the asymmetric mean is left out of the average because of its high volatility in recent months (as discussed in Chapter I), core inflation at the end of September would stand at 9.0%, up by 0.1 percentage points on the June level.

✠ Producer inflation, measured as annual change in the Producer Price Index (PPI), was 12.9% at the end of September, two percentage points higher than a year earlier and 2.7 points lower than in June. The drop in producer inflation since June resulted mostly from a slower price variation in industrial goods and farm produce, in spite of a large increase in mining prices caused by rising fuel prices.

✠ Core inflation, calculated as the average of all the four indicators, is presently projected to be 8.2% by December, 0.3 percentage points below the June forecast; leaving out the asymmetric mean, it would be 8.7%, much as it was in June.

✠ At the end of the third quarter, the monetary base's 20-month moving average stood 2.8% above the corridor ceiling. This was because of faster growth in the average cash balance than is implicitly envisaged in the corridor's upper limit. As pointed out appropriately in the June Report and confirmed in this one, the faster growth being shown by the more liquid monetary aggregates (monetary base and M1) has been due to an increase in demand for cash caused by various factors, notably low interest rates and extension of the two-per-thousand levy on financial transactions. This increase should not therefore affect prices by raising aggregate demand by more than originally forecast.

✠ The financial system's nominal and real loan portfolios continued to shrink in the third quarter at much the same rates as in the second. The exception was the portfolio of the private financial institutions, excluding the savings and loan corporations (CAVs) and mortgage banks; it continued to grow, by about 3.5%. The portfolio indicator, obtained by adding to the gross portfolio the loans removed by financial intermediaries from their balances in the past 18 months) showed a 3.5% annual growth in August for the financial system as a whole. Lastly, nominal and real interest rates were higher at the end of the third quarter than in June. In September the nominal deposit rate averaged 12.9% and the nominal lending rate 28.9%, up by 0.9 and 5.0 percentage points respectively on the June levels. Over the same period, the real deposit rate rose by 0.8 percentage points to 3.4%, remaining below the historical average, while the real lending rate rose by 3.4 percentage points to 18.1%, exceeding the historical average.

✠ Economic expansion continued at much the same pace as in the second quarter, as evidenced by the different indicators of the real sector. The fastest growth was in the industrial sector and non-traditional exports, with significant signs of recovery being shown also by such other sectors as commerce and services. Likewise, the recent behavior of industrial orders and stocks, and businessmen's favorable expectations allow of optimism about economic growth in the following months. This perception is further supported by current interest-rates levels and the promising outlook for international growth. Economic recovery has brought with it a pick-up in the various indicators of installed capacity, which now stand close to their historical averages. Yet, production levels in most sectors are still lower than they were before the recession, so that no major inflationary pressures are expected to arise from demand in the next few months

✠ Slower devaluation in recent weeks has been reflected in lower inflation forecasts for December of this year and next, making it more likely in principle that the 8.0% target for 2001 will be met. All the same, exchange-rate volatility, and the highly uncertain nature of inflation forecasts made more than a year ahead, call for great prudence in weighing existing risks. These risks are still associated with a possible pick-up in food prices owing to cyclical factors and, to a lesser extent, with further increases in fuel prices. Moreover, though stability may reasonably be expected on the exchange front for the rest of this year, there is still a high degree of uncertainty in this regard for next year. Similarly, a possible surprise in housing rents for 2001 cannot be ruled out, especially since the crisis in the construction sector may have considerably reduced the availability of housing for rent. Lastly, empirical domestic and international evidence suggests that reforming the structure of the value-added tax tends to have a favorable effect on inflation in the long run, by contributing to fiscal equilibrium, but can produce adverse effects on prices in the short run.

✠ Given the satisfactory behavior of prices in September, consistent with the 10.0% inflation target for this year, the stability shown by core inflation, and the lowering of several inflation and core-inflation forecasts for 2000 and 2001, the Board has decided to maintain its policy stance unchanged.

The Board of Directors,

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