LATIN AMERICAN CENTRAL BANKS (CBs) MONETARY POLICY AND FINANCIAL STABILITY - THE CASE OF COLOMBIA -

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The independence of the CB of Colombia

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

- By our constitutional mandate, “the primary goal of monetary policy is price stability, in coordination with the objectives of general economic policy”.

- Since 1999, the BR has used a flexible Inflation Targeting strategy to handle monetary policy. The policy objectives in this strategy are (i) the maintenance of low and stable inflation (3% +/- 1%); (ii) the smoothing of output fluctuations around a sustainable growth path; and (iii) the contribution to financial stability.

The main instrument and rule for monetary policy

- The BR'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 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.

Exchange rate floating regime (1)

- In a commodity-exporting, small, open economy with price/wage rigidities, like 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-sheet.

- Pass-through is limited by the anchoring of inflation expectations and the credibility of monetary policy.

The long term inflation target has been reached

- Inflation converged to its long term target (3% +/- 1%) throughout the first decade of the century. The long term target has been met every year since 2009 and the targets have provided a sound anchor for inflation expectations.

- After the Lehman shock, the exchange rate was allowed to act as a buffer and interest rates were rapidly reduced to support the economy.

- The reduction in the policy rate was quickly transmitted to deposit and lending interest rates. As a result, financial system credit rebounded and supported economic growth.

Recent economic performance as a driver for monetary policy

- The Colombian economy has performed relatively well in comparison to the region.
- Average GDP growth in the four quarters between June 2013 and June 2014 was 5.5%, up from 3.2% observed in the previous four quarters. During the last decade the average was 4,7%, close to its potential.
- The strength of the Colombian economy contrasts with slow growth in other economies in the region and the rest of the emerging world.

Counter-cyclicality, the key (1)

- First, low real interest rates were in effect for almost two years, due to excess capacity observed beginning in the second half of 2012 and 2013 and the behavior of inflation, which ended in 2013 slightly below the lower limit of the target range (1.94%).
- Low real interest rates and high levels of consumer and producer confidence stimulated the growth of household consumption and private investment.

Counter-cyclicality, the key (2)

Second, investment in civil works and construction as well as government consumption have fueled public domestic demand in a context of weak external demand and falling terms of trade.

Normalization of monetary policy

- The strength of domestic demand closed the output gap throughout 2014. This, along with the convergence of inflation and its expectations to the target (from below), led the Board of BR to increase the interest rate policy from 3.25% in April 2014 to 4.5% in August. The objective was to gradually normalize monetary policy.

- Nevertheless, in my opinion it is foreseeable a slowdown this year (around 3,5% growth of GDP vs. 4,7% in 2014), especially due to the slump in the price of oil. Oil accounts for more than half of exports, a sixth of government's revenues and 80% of FDI inflows. The fiscal and current account deficits could reach 3% and 5% of GDP respectively by the end of 2015.

Inflation

- Inflation in 2014 was 3.66%, close to the upper limit of the target range, as short term supply factors (particularly food prices) that pushed it down in 2013 are undone.

- Whereas 'core' inflation (excluding food and regulated public services) was 2,81%.

- Inflation expectations for December 2015 are well anchored to 3%.

The results

- The monetary policy strategy adopted in Colombia in 1999 has proved to be successful.
- Inflation converged to its long term target and a *counter-cyclical* monetary policy response to external shocks could be adopted.
- Hence, not only were productivity, investment and welfare enhanced, but resilience to external shocks was also strengthened.

The 3-‘pillars’ macroeconomic policy framework

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

The challenge ahead: consolidating a second instrument under CBs for financial stability

- According to the statutory framework, most CBs must be responsible for both monetary policy and financial stability.
- That means that CBs should have two instruments instead of one: the interest rate and its related tools (for monetary policy), and, additionally, macro-prudential regulation (for financial stability).
- In other words, in order to be effective and efficient in the fulfillment of its role, CBs should be both the monetary authority and the macro-prudential regulator.

Some of the main roots of financial crisis

- Excessive exposure to financial risks, above all during the so-called 'good times'.

- During the last 30 years, this exposure was exacerbated by the much celebrated and lauded 'financial revolutions', which provoked the largest bubbles and 'manias' in the real estate and securities markets.

- Some of the latest credit and financial ‘innovations’ have created the capacity to issue currency that goes beyond the reach of the CBs’ monopoly or control on growth of the amount of money in circulation. As a consequence, the efforts of today’s CBs could easily end up being offset by new and very near substitutes for the latter.

The main lessons from the crisis

- Targeting price stability is not enough to achieve financial stability.

- Investors do not respond to the 'efficient market' theory, which is based on the false assumption of absolute rationality on the part of economic agents.

- The financial system has an inherent *pro-cyclical* nature and severe dificulties for genuine self-regulation.

- Assets prices do matter - and very much -, for monetary policy and financial stability concerns.

- In order to be able to prevent, or at least mitigate, assets bubbles, CBs must be fully empowered to regulate and control the credit channel.

CBs' responsability for financial stability in advanced countries

"…in the run-up to the crisis, financial vulnerabilities grew unchecked as central banks were focused on preserving price stability—while regulators were regulating financial institutions from an idiosyncratic perspective. To prevent similar crises from erupting in the future, several advanced countries, including the United States (U.S.), the United Kingdom (U.K), and others in the European Union, have already introduced major legal reforms that assign central banks a more active role in preserving financial stability."

(L. Jácome, IMF, 2014)

The second instrument

- Rather than distorting the use of a traditional instrument such as the interest rate to achieve that second objective, what we need is a second instrument with *counter-cyclical* features of the kind that make it possible to exercise effective control over growth in the loan portfolio during asset price booms.

- The idea is to steer regulation towards dealing with the systemic risks in the financial sector as a whole, as opposed to addressing isolated parts. This means supplementing the conventional objective of monetary policy by adding the mandate to anticipate potential asset price bubbles. For that reason, regulating the supply of credit is crucial.

Some tools of macro-prudential regulation (apart from interest rates, reserve requirements and capital controls)

- Minimum liquidity and capital requirements for intermediaries
- Ordinary and *counter-cyclical* provisions
- Leveraging limits
- Criteria on risk management and investment portfolio diversification
- Limits on loan-to-value and loan-to-income ratios for housing and other consumer durables
- Prevention of currency and maturity mismatches
- *Counter-cyclical* capital requirements for intermediaries, according to credit performance

Thank you