MONETARY POLICY IN COLOMBIA: FUNDAMENTALS, STRENGTHS AND DILEMMAS*

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*Personal opinions

The independence of the CB of Colombia

- The BC 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 BC 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 BC'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

- Between 2005 and 2014 the Colombian economy performed relatively well in comparison to the region.

- Average GDP growth during that decade 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 the BC to increase the interest rate policy from 3.5% in April 2014 to 4.5% in August. The objective was to gradually normalize monetary policy.

- Nevertheless, according to the staff it is foreseeable a substantial slowdown this year (2.8% growth of GDP vs. 4.7% in 2014), especially due to the slump of oil prices. 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 3.5% and 6.5% of GDP respectively by the end of 2015.

Inflation

- Inflation in 2014 was 3.7%, 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 2.8%.
- Inflation expectations for December 2015 so far have been anchored to the target.

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.

Finally, the 3-‘pillars’ of the colombian macroeconomic policy framework have been:

- Inflation targeting and exchange rate flexibility: BC's role.
- Fiscal policy based on ‘the medium term fiscal framework’ and a 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).

2015: dilema triggered by the fall of oil prices and its impact on income and the weakening of the currency

- The CB now faces a dilema: while the economy is decelerating and below potential GDP, inflation has been steadily going up (4.7%), and has remained during the last seven months above the upper limit of the target.
- The problem is no longer originated in food inflation. Even excluding food, inflation continues ascending, and has already surpassed the upper limit of the target.
- ‘Core’ inflation is also above the upper limit, and in August went up further for eleventh consecutive month. Meanwhile, the CB’s real policy interest rate of the last six months has been close to cero (negative in August).

How should respond the monetary authority?

- In my opinion, the dilemma should be resolved depending on the behavior of inflation expectations, the key measure of the credibility of the monetary policy.
- Its main indicators were still anchored to the target until last month. But now seem to be looking and moving upwards.

Thank you