Box 1: Inflation Report June 2016

Keep in mind

The Monetary Policy Report presents the Bank's technical staff's analysis of the economy and the inflationary situation and its medium and long-term outlook. Based on it, it makes a recommendation to the Board of Directors on the monetary policy stance. This report is published on the second business day following the Board of Directors' meetings in January, April, July, and October.

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Abrupt and sudden movements in the exchange rate are a cause for concern among monetary authorities, because they can jeopardize compliance with the inflation target as a result of higher import and other prices in the economy, and given their impact on inflation expectations. This concern has been evident since July 2014, when the peso depreciated sharply. That depreciation peaked in February 2016 and coincided with the collapse of oil prices. Between those two dates, the representative market exchange rate (TRM by its acronym in Spanish) increased 81% and the consumer price index (CPI) rose 11%.

It is, therefore, essential to look at how, how much, and in what time frame disturbances in the exchange rate are passed through to prices all along the distribution chain in the economy. In other words, it is important to analyze what is referred to in the literature as “exchange rate pass-through” on prices, and to assess what variables affect the degree of that pass-through. Consequently, given the significance of this issue for Banco de la República, the purpose of this section is to answer these questions through the use of advanced econometric techniques and monthly statistics on the Colombian economy for the 2002-2015 period.

Recent theoretical and empirical literature highlights the fact that the degree of exchange-rate pass-through to prices is less than proportional, because it depends on the market power of importing companies and producers in the domestic market, the degree of price rigidity in the economy, the sign, size, volatility and nature of fluctuations in the exchange rate (temporary versus permanent), and the state of the economy. To control for the latter, we use measures of the output gap, the degree of real exchange-rate misalignment, the degree of economic openness, accelerating inflation, etc. Then, we define two regimes (high and low) for each of them, and estimate the degree of pass-through in each case.