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Pursuant to Article 5 of Law 31 of 1992, the Board of Directors of Banco de la República (the Central Bank of Colombia) submits a report to the Honorable Congress of Colombia, informing about the performance of the economy and its outlook. This report is submitted twice a year, in March and July, within ten business days following the start date of the sessions of the Congress.

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Complying with Article 5 of Act 31 of 1992, the Board of Directors of the Central Bank submits a report to the Congress of Colombia twice a year accounting for the behavior of the economy and its prospects. This report is delivered in March and July within 10 working days following the beginning of the sessions of the Congress.

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Introduction

Banco de la República is celebrating its 100th anniversary in 2023. This is a very significant anniversary and one that provides an opportunity to highlight the contribution the Bank has made to the country's development. Its track record as guarantor of monetary stability has established it as the one independent state institution that generates the greatest confidence among Colombians due to its transparency, management capabilities, and effective compliance with the central banking and cultural responsibilities entrusted to it by the Constitution and the Law. On a date as important as this, the Board of Directors of Banco de la República (BDBR) pays tribute to the generations of governors and officers whose commitment and dedication have contributed to the growth of this institution.[1]

Banco de la República's mandate was confirmed in the National Constitutional Assembly of 1991 where the citizens had the opportunity to elect the seventy people who would have the task of drafting a new constitution. The leaders of the three political movements with the most votes were elected as chairs to the Assembly, and this tripartite presidency reflected the plurality and the need for consensus among the different political groups to move the reform forward.

Among the issues considered, the National Constitutional Assembly gave special importance to monetary stability. That is why they decided to include central banking and to provide Banco de la República with the necessary autonomy to use the instruments for which they are responsible without interference from other authorities. The constituent members understood that ensuring price stability is a state duty and that the entity responsible for this task must be enshrined in the Constitution and have the technical capability and institutional autonomy necessary to adopt the decisions they deem appropriate to achieve this fundamental objective in coordination with the general economic policy. In particular, Article 373 established that "the State, through Banco de la República, shall ensure the maintenance of the purchasing power of the currency," a provision that coincided with the central banking system adopted by countries that have been successful in controlling inflation. In 1999, in Ruling 481, the Constitutional Court stated that "the duty to maintain the purchasing power of the currency applies to not only the monetary, credit, and exchange authority, i.e., the Board of Banco de la República, but also those who have responsibilities in the formulation and implementation of the general economic policy of the country" and that "the basic constitutional purpose of Banco de la República is the protection of a sound currency. However, this authority must take the other economic objectives of state intervention such as full employment into consideration in their decisions since these functions must be coordinated with the general economic policy."

The reforms to Banco de la República agreed upon in the Constitutional Assembly of 1991 and in Act 31/1992 can be summarized in the following aspects: i) the Bank was assigned a specific mandate: to maintain the purchasing power of the currency in coordination with the general economic policy; ii) the BDBR was designatedas the monetary, foreign exchange, and credit authority; iii) the Bank and its Board of Directors were granted a significant degree of independence from the government; iv) the Bank was prohibited from granting credit to the private sector except in the case of the financial sector; v) established that in order to grant credit to the government, the unanimous vote of its Board of Directors was required except in the case of open market transactions; vi) determined that the legislature may, in no case, order credit quotas in favor of the State or individuals; vii) Congress was appointed, on behalf of society, as the main addressee of the Bank's reporting exercise; and viii) the responsibility for inspection, surveillance, and control over Banco de la República was delegated to the President of the Republic.

The members of the National Constitutional Assembly clearly understood that the benefits of low and stable inflation extend to the whole of society and contribute mto the smooth functioning of the economic system. Among the most important of these is that low inflation promotes the efficient use of productive resources by allowing relative prices to better guide the allocation of resources since this promotes economic growth and increases the welfare of the population. Likewise, low inflation reduces uncertainty about the expected return on investment and future asset prices. This increases the confidence of economic agents, facilitates long-term financing, and stimulates investment. Since the low-income population is unable to protect itself from inflation by diversifying its assets, and a high proportion of its income is concentrated in the purchase of food and other basic goods that are generally the most affected by inflationary shocks, low inflation avoids arbitrary redistribution of income and wealth.[2] Moreover, low inflation facilitates wage negotiations, creates a good labor climate, and reduces the volatility of employment levels. Finally, low inflation helps to make the tax system more transparent and equitable by avoiding the distortions that inflation introduces into the value of assets and income that make up the tax base. From the monetary authority's point of view, one of the most relevant benefits of low inflation is the credibility that economic agents acquire in inflation targeting, which turns it into an effective nominal anchor on price levels.

Upon receiving its mandate, and using its autonomy, Banco de la República began to announce specific annual inflation targets as of 1992. Although the proposed inflation targets were not met precisely during this first stage, a downward trend in inflation was achieved that took it from 32.4% in 1990 to 16.7% in 1998. At that time, the exchange rate was kept within a band. This limited the effectiveness of monetary policy, which simultaneously sought to meet an inflation target and an exchange rate target. The Asian crisis spread to emerging economies and significantly affected the Colombian economy. The exchange rate came under strong pressure to depreciate as access to foreign financing was cut off under conditions of a high foreign imbalance. This, together with the lack of exchange rate flexibility, prevented a countercyclical monetary policy and led to a 4.2% contraction in GDP that year. In this context of economic slowdown, annual inflation fell to 9.2% at the end of 1999, thus falling below the 15% target set for that year. This episode fully revealed how costly it could be, in terms of economic activity, to have inflation and exchange rate targets simultaneously.

Towards the end of 1999, Banco de la República announced the adoption of a new monetary policy regime called the Inflation Targeting Plan. This regime, known internationally as 'Inflation Targeting,' has been gaining increasing acceptance in developed countries, having been adopted in 1991 by New Zealand, Canada, and England, among others, and has achieved significant advances in the management of inflation without incurring costs in terms of economic activity. In Latin America, Brazil and Chile also adopted it in 1999. In the case of Colombia, the last remaining requirement to be fulfilled in order to adopt said policy was exchange rate flexibility. This was realized around September 1999, when the BDBR decided to abandon the exchange-rate bands to allow the exchange rate to be freely determined in the market.

Consistent with the constitutional mandate, the fundamental objective of this new policy approach was "the achievement of an inflation target that contributes to maintaining output growth around its potential."[3] This potential capacity was understood as the GDP growth that the economy can obtain if it fully utilizes its productive resources. To meet this objective, monetary policy must of necessity play a countercyclical role in the economy. This is because when economic activity is below its potential and there are idle resources, the monetary authority can reduce the interest rate in the absence of inflationary pressure to stimulate the economy and, when output exceeds its potential capacity, raise it. This policy principle, which is immersed in the models for guiding the monetary policy stance, makes the following two objectives fully compatible in the medium term: meeting the inflation target and achieving a level of economic activity that is consistent with its productive capacity.

To achieve this purpose, the inflation targeting system uses the money market interest rate (at which the central bank supplies primary liquidity to commercial banks) as the primary policy instrument. This replaced the quantity of money as an intermediate monetary policy target that Banco de la República, like several other central banks, had used for a long time.

In the case of Colombia, the objective of the new monetary policy approach implied, in practical terms, that the recovery of the economy after the 1999 contraction should be achieved while complying with the decreasing inflation targets established by the BDBR. The accomplishment of this purpose was remarkable. In the first half of the first decade of the 2000s, economic activity recovered significantly and reached a growth rate of 6.8% in 2006. Meanwhile, inflation gradually declined in line with inflation targets. That was how the inflation rate went from 9.2% in 1999 to 4.5% in 2006, thus meeting the inflation target established for that year while GDP reached its potential level. After this balance was achieved in 2006, inflation rebounded to 5.7% in 2007, above the 4.0% target for that year due to the fact that the 7.5% GDP growth exceeded the potential capacity of the economy.[4]

After proving the effectiveness of the inflation targeting system in its first years of operation, this policy regime continued to consolidate as the BDBR and the technical staff gained experience in its management and state-of-the-art economic models were incorporated to diagnose the present and future state of the economy and to assess the persistence of inflation deviations and expectations with respect to the inflation target. Beginning in 2010, the BDBR established the long-term 3.0% annual inflation target, which remains in effect today.

Lower inflation has contributed to making the macroeconomic environment more stable, and this has favored sustained economic growth, financial stability, capital market development, and the functioning of payment systems. As a result, reductions in the inflationary risk premia and lower TES and credit interest rates were achieved. At the same time, the duration of public domestic debt increased significantly going from 2.27 years in December 2002 to 5.86 years in December 2022, and financial deepening, measured as the level of the portfolio as a percentage of GDP, went from around 20% in the mid-1990s to values above 45% in recent years in a healthy context for credit institutions.

Having been granted autonomy by the Constitution to fulfill the mandate of preserving the purchasing power of the currency, the tangible achievements made by Banco de la República in managing inflation together with the significant benefits derived from the process of bringing inflation to its long-term target, make the BDBR's current challenge to return inflation to the 3.0% target even more demanding and pressing. As is well known, starting in 2021, and especially in 2022, inflation in Colombia once again became a serious economic problem with high welfare costs. The inflationary phenomenon has not been exclusive to Colombia and many other developed and emerging countries have seen their inflation rates move away from the targets proposed by their central banks.[5] The reasons for this phenomenon have been analyzed in recent Reports to Congress, and this new edition delves deeper into the subject with updated information.

The solid institutional and technical base that supports the inflation targeting approach under which the monetary policy strategy operates gives the BDBR the necessary elements to face this difficult challenge with confidence. In this regard, the BDBR reiterated its commitment to the 3.0% inflation target in its November 25 communiqué and expects it to be reached by the end of 2024.[6] Monetary policy will continue to focus on meeting this objective while ensuring the sustainability of economic activity, as mandated by the Constitution. Analyst surveys done in March showed a significant increase (from 32.3% in January to 48.5% in March) in the percentage of responses placing inflation expectations two years or more ahead in a range between 3.0% and 4.0%. This is a clear indication of the recovery of credibility in the medium-term inflation target and is consistent with the BDBR's announcement made in November 2022. The moderation of the upward trend in inflation seen in January, and especially in February, will help to reinforce this revision of inflation expectations and will help to meet the proposed targets.

After reaching 5.6% at the end of 2021, inflation maintained an upward trend throughout 2022 due to inflationary pressures from both external sources, associated with the aftermath of the pandemic and the consequences of the war in Ukraine, and domestic sources, resulting from: strengthening of local demand; price indexation processes stimulated by the increase in inflation expectations; the impact on food production caused by the mid-2021 strike; and the pass-through of depreciation to prices. The 10% increase in the minimum wage in 2021 and the 16% increase in 2022, both of which exceeded the actual inflation and the increase in productivity, accentuated the indexation processes by establishing a high nominal adjustment benchmark. Thus, total inflation went to 13.1% by the end of 2022. The annual change in food prices, which went from 17.2% to 27.8% between those two years, was the most influential factor in the surge in the Consumer Price Index (CPI). Another segment that contributed significantly to price increases was regulated products, which saw the annual change go from 7.1% in December 2021 to 11.8% by the end of 2022. The measure of core inflation excluding food and regulated items, in turn, went from 2.5% to 9.5% between the end of 2021 and the end of 2022. The substantial increase in core inflation shows that inflationary pressure has spread to most of the items in the household basket, which is characteristic of inflationary processes with generalized price indexation as is the case in Colombia.

Monetary policy began to react early to this inflationary pressure. Thus, starting with its September 2021 session, the BDBR began a progressive change in the monetary policy stance moving away from the historical low of a 1.75% policy rate that had intended to stimulate the recovery of the economy. This adjustment process continued without interruption throughout 2022 and into the beginning of 2023 when the monetary policy rate reached 12.75% last January, thus accumulating an increase of 11 percentage points (pp). The public and the markets have been surprised that inflation continued to rise despite significant interest rate increases. However, as the BDBR has explained in its various communiqués, monetary policy works with a lag. Just as in 2022 economic activity recovered to a level above the pre-pandemic level, driven, along with other factors, by the monetary stimulus granted during the pandemic period and subsequent months, so too the effects of the current restrictive monetary policy will gradually take effect. This will allow us to expect the inflation rate to converge to 3.0% by the end of 2024 as is the BDBR's purpose.

Inflation results for January and February of this year showed declining marginal increases (13 bp and 3 bp respectively) compared to the change seen in December (59 bp). This suggests that a turning point in the inflation trend is approaching. In other Latin American countries such as Chile, Brazil, Perú, and Mexico, inflation has peaked and has begun to decline slowly, albeit with some ups and downs. It is to be expected that a similar process will take place in Colombia in the coming months. The expected decline in inflation in 2023 will be due, along with other factors, to lower cost pressure from abroad as a result of the gradual normalization of supply chains, the overcoming of supply shocks caused by the weather, and road blockades in previous years. This will be reflected in lower adjustments in food prices, as has already been seen in the first two months of the year and, of course, the lagged effect of monetary policy. The process of inflation convergence to the target will be gradual and will extend beyond 2023. This process will be facilitated if devaluation pressure is reversed. To this end, it is essential to continue consolidating fiscal sustainability and avoid messages on different public policy fronts that generate uncertainty and distrust.

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1 This Report to Congress includes Box 1, which summarizes the trajectory of Banco de la República over the past 100 years. In addition, under the Bank's auspices, several books that delve into various aspects of the history of this institution have been published in recent years. See, for example: Historia del Banco de la República 1923-2015; Tres banqueros centrales; Junta Directiva del Banco de la República: grandes episodios en 30 años de historia; Banco de la República: 90 años de la banca central en Colombia.

2 This is why lower inflation has been reflected in a reduction of income inequality as measured by the Gini coefficient that went from 58.7 in 1998 to 51.3 in the year prior to the pandemic.

3 See Gómez Javier, Uribe José Darío, Vargas Hernando (2002). "The Implementation of Inflation Targeting in Colombia". Borradores de Economía, No. 202, March, available at: https://repositorio.banrep.gov.co/handle/20.500.12134/5220

4 See López-Enciso Enrique A.; Vargas-Herrera Hernando and Rodríguez-Niño Norberto (2016). "The inflation targeting strategy in Colombia. An historical view." Borradores de Economía, No. 952. https://repositorio.banrep.gov.co/handle/20.500.12134/6263

5 According to the IMF, the percentage change in consumer prices between 2021 and 2022 went from 3.1% to 7.3% for advanced economies, and from 5.9% to 9.9% for emerging market and developing economies.

6 https://www.banrep.gov.co/es/noticias/junta-directiva-banco-republica-r…