Banrep Minutes: The Board of Directors of Banco de la República, by a majority vote, opted to reduce the monetary policy interest rate by 25 basis points (bps) to 12.75%

Attachments

Determinantes de las Dinámicas de los Mercados de Capitales (Only Available in Spanish) Anexo estadístico (Only Available in Spanish)

- By December, annual inflation had dropped for the ninth consecutive month and closed the year at 9.28%, in line with the technical staff's December projection. Food and goods (excluding food and regulated items) fronted the inflationary decline, standing at 5% and 7.1% by yearend, respectively. Conversely, regulated items inflation rose to 17.2%, while an upside surprise came from the services basket (excluding regulated items), which continues to record high inflation rates of close to 9%.
- Most future inflation expectation measures fell, suggesting a downward trend over time. The Bank's monthly survey of economic analyst expectations conducted by Banco de la República found that the sample median one-year expectations dropped from 5.7% to 5.2%, and two-year expectations from 3.8% to 3.6% between December and January. Similarly, adjusted expectations drawn from the public debt markets showed a decrease across all maturities.
- The technical staff maintains a growth estimate of 1% for 2023 and 0.8% for 2024, compatible with long-term sustainable output levels and the convergence of inflation towards its target. Lower domestic demand is reflected in a narrowing of the current account deficit as a share of GDP from 6.2% in 2022 to 2.8% in 2023, reaching 2.9% in 2024. The correction of the country's external imbalance makes the economy less vulnerable to a significant decline in global conditions.
- External financial conditions have improved amid declining global inflation and a slower-than-projected deceleration of the world economy. In this context, Colombia's sovereign risk premium fell in 2023, and the peso appreciated at a higher rate than the currency of comparable countries in the region.
- The increase in the minimum wage for 2024 exceeded expectations, which influences the price path projected by the technical staff, especially in the services basket. There are also potential risks derived from the El Niño phenomenon on food and energy prices and possible adjustments in the prices of regulated items, which may impact the outlook.

All Board members agreed on the existing positive conditions that favor a continued reduction of the policy interest rate, highlighting the inflationary decline during December despite the high inflation seen in regulated items. Moreover, both market-based and survey-based inflation expectations for the various terms have decreased. The Directors highlighted the slowing pace of economic activity, which exhibited a -0.3% variation in the third quarter of 2023, resulting from the significant contraction of investment, primarily in the housing, machinery and equipment, and civil works sectors. They stressed that the slower tempo of economic activity is already reflected in the concurrent slowdown in the labor market. With this in mind, the Directors differed on the amount of the policy rate reduction they considered appropriate under the current circumstances. Five Directors voted for a 25-bps reduction, while two voted for a 50-bps cut.

The Directors who voted for a 25-bps reduction underscored that a faster decrease of the policy rate under current conditions risks eroding the credibility of the inflationary target. This attrition could impede further progress in the rate reduction process and monetary policy easing, resulting in higher costs to the national economy. They warned that, despite the reduction in inflation, it continues well above the target. While expectations have fallen, not all are consistent with achieving said target in the 12 to 18-month horizon announced by the Board last November. They stressed their concern regarding the behavior of the services basket, whose inflation has shown significant downward rigidity. They highlighted that the approach of inflation to the target faces significant risks in the form of severe drought caused by the El Niño phenomenon. They consider that the potential detrimental effects on the credibility of the short-term inflation target after three consecutive years of non-fulfillment require special caution in exercising monetary policy to prevent weather-related increases in food or utility prices from becoming sources of generalized inflationary pressures. Given the recent decline in inflation expectations, they emphasize that a 25-bps reduction in the policy rate maintains the real interest rate largely unchanged. The Directors note this is a prudent stance under the current circumstances, allowing time to assess the true extent of the El Niño phenomenon, evaluate the common rent and education price hikes that occur early in the year, and assess the potential effects of the recent minimum wage increase. They point out the fiscal uncertainty regarding the nature and certitude of some revenue sources in the national Financial Plan for 2024 and in the Government's Medium-Term Fiscal Framework to be published in June, which would require clarification. Overall, this group of Directors holds to the expectation of accommodating greater policy rate reductions in the coming months as current uncertainty sources dissipate.

The Board members who voted for a 50-bps reduction noted that the contractionary monetary policy stance implemented since September 2021 has been generating the necessary macroeconomic adjustment, as evidenced by the slowdown of aggregate demand to levels compatible with productive capacity, resulting from the deceleration of consumption and the sharp decline in investment. In the same vein, the current account deficit has seen a significant correction, reducing, in turn, the economy's external vulnerability and the fiscal deficit in the year that just ended. This can be seen through inflation that continues to decline, along with a downward revision in its expectations, amid a growth environment that will remain weak into 2024, according to the technical staff's projections. The Directors add that the labor market shows signs of weakening, notable in the higher unemployment rate seen in the seasonally adjusted series and the greater number of working-age individuals outside the labor force (inactive population). They warn that the annual industry employment growth rate has been negative since May, caused by the reduction in temporary employees. With the lower GDP growth projections for 2024, these trends could become more pronounced. Within this framework, they insist on the need to recover an upward investment path, thus reversing the sharp decline suffered in 2023, which would benefit notably from a substantial reduction in the policy rate by alleviating financing costs, one of the critical factors in investment decision-making. They believe that, against this backdrop, such a moderate cut in the policy rate would maintain the real interest rate firmly in contractionary territory, delaying the growth stimulus that the economy urgently requires and causing needless economic costs.

The members of the Board of Directors agreed that, with the decision adopted at this meeting, the economy will continue its necessary adjustment process for inflation to converge towards the target by the first half of 2025 at the latest. Likewise, they reiterate that future decisions will be determined based on new information available.

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