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I. Conceptual Considerations on Monetary Policy

As I have done in some recent presentations, I would like to begin this presentation with a general reflection. Specifically, I would like to reiterate something that may seem obvious to you but is nonetheless important. I am referring to the fact that the main objective assigned to *Banco de la República* and its Board of Directors by the Constitution is to preserve the purchasing power of the currency in coordination with the general economic policy. This has been implemented by the Board through what is known as the inflation target strategy, aimed at maintaining inflation around 3.0%, with exchange rate flexibility and the short-term interest rate as the main instrument.

The relationship between the objective of low and stable inflation and economic growth is complex. Typically, a contractionary monetary policy stance aimed at reducing inflation leads to an economic slowdown in the short term. However, the impact of that same policy and the achievement of low and stable inflation is clearly favorable for economic growth over a longer time horizon. This paradox is precisely what has led most of the world to grant central banks autonomy, ensuring that their decisions are not overly biased by short-term considerations, which are typically of greater importance to the governments in power.

A stable inflation of around 3.0% allows for higher sustainable economic growth for several reasons:

- Firstly, it creates stability and predictability conditions in general price levels, facilitating decision-making for companies, investors, and consumers.
- Secondly, but not less important, stable inflation at low levels is essential for maintaining sustainably low interest rates. No saver would be willing to purchase a long-term certificate of deposit (CDT in Spanish) at low interest rates if they believed inflation could erode the expected returns on those investments. Likewise, no bank will be willing to grant a fixed-rate mortgage loan for a 15- or 20-year term if they expect inflation to rise in the future, leading to increased short-term rates and funding costs.

On the other hand, maintaining low and stable inflation allows monetary policy to act countercyclically, tightening with higher interest rates in aggregate demand boom cycles that typically generate inflationary pressures and lowering those rates during periods when demand and economic activity decline, as happened during the COVID-19 crisis in 2020.

Unfortunately, there are conditions where maintaining a contractionary monetary policy is necessary to lower inflation, even when economic activity has slowed down and there is no evidence of excess demand. This occurs, for example, when prices and wages are heavily indexed to past inflation. It also happens when country risk spread increases, such as those that have occurred recently, due to both global uncertainty and idiosyncratic factors, such as increases in public debt and higher-than-expected fiscal deficits.

Such conditions impose a greater burden on restrictive monetary policies, making them more difficult and costly in terms of the temporary sacrifice required in terms of the pace of economic activity and employment to bring inflation down to the desired level, ultimately restoring the possibility of stronger medium and long-term growth.

While these general considerations may seem excessively theoretical, they are essential for analyzing what has recently happened to Colombia's macroeconomic conditions. In fact, as we will see throughout this presentation, in recent years, we have had to implement a highly restrictive monetary policy, even more so than in neighboring countries, such as Chile or Perú, where inflation faced fewer restrictions to decline. Nevertheless, I dare say that, fortunately, our policy has been successful in reducing inflation, and it has been adjusted in a way that, while it has had short-term costs in terms of economic activity and employment, these costs have been significantly lower than what many initially anticipated.

With these general considerations, I will now discuss in greater detail the Bank's view of the impact of the recent contractionary monetary policy on economic activity, employment, and financial activity and of course, inflation development and its expectations. In this context, I will later discuss the importance of the Bank's cautious approach in the process of reducing policy interest rates and the reasons why this caution has increased in the last two Board meetings.

At the end of my presentation, I will additionally make some remarks on the expected role of *Banco de la República* in managing saving resources that will be generated by the pension system in accordance with the reform approved by Congress last year, which requires urgent regulations by the Colombian Government.

II. Adjustment in Demand, Economic Activity, Employment, and Credit

Banco de la República began implementing contractionary monetary policy through interest rates increases in September 2021, and it reached its higher intensity peak between April and December 2023, when the policy interest rate remained at 13.25%.

This policy undoubtedly had a significant impact on domestic demand, which, although painful, not only helped to initiate the inflation adjustment process but also reduced the excess demand that had resulted in a very high current account deficit in the country's balance of payments. This deficit reached 6.1% of GDP in 2022, an indicator that certainly implied significant external vulnerability for the Colombian economy at the time. The adjustment process on this front has been substantial. The current deficit of the balance of payments decreased to an average of 1.7% of GDP in the first three quarters of 2024, less than one-third of what it was two years earlier. The Bank's technical staff estimates that this deficit could rise to 2.5% of GDP in 2025, a figure which, in any case, would remain significantly lower than what we observed in 2022.

Regarding economic activity, the adjustment process was significant in 2023, but the most recent period indicates a clear recovery:

- After two years of extremely high and unsustainable GDP growth in 2021 and 2022 (10.8% and 7.3%, respectively), economic activity slowed down to 0.6% in 2023.
- However, since the last quarter of 2023, when there was a 0.7% drop, GDP growth has been positive and increasing each quarter. With seasonality and calendar-adjusted figures, growth was 0.5% in the last quarter of that year and in the first three quarters of 2024, rising to 0.9%, 1.8%, and 2.0%, respectively. Additionally, according to the Monetary Policy Report released by the Bank's technical staff last week, the estimated growth for the last quarter of 2024 was 2.3%,

thus maintaining the positive trend in economic dynamism recovery.

- For the full year of 2024, the Bank's technical staff forecasts a growth of 1.8%, although this figure reflects highly heterogeneous performance across different sectors, with positive results in agriculture and services but rather weak outcomes in manufacturing and construction. The expected growth for 2025 is 2.6%, and for 2026, 3.4%, figures broadly aligned with the estimated potential growth of the Colombian economy.
- In this context, it is also worth highlighting that, despite the significant monetary adjustment required to reduce inflation, labor market indicators have shown remarkable resilience. The unemployment rate reported by the National Administrative Department of Statistics (DANE) stood at 9.1%, significantly lower than the 10% recorded in December 2023. In turn, the employed population in December 2024 was 756,000 higher than a year earlier, showing a 3.3% growth. More generally, it can be said that over the last few years total employment has continued to grow and both informality and unemployment rates are lower than those observed before the pandemic. It would, indeed, be desirable for these rates to be even lower, but this would require structural policies beyond the scope of the monetary policy set by *Banco de la República*.
- Regarding the financial sector, the high interest rates we have seen during the recent macroeconomic adjustment process have led to a significant slowdown in credit growth, together with a deterioration in credit quality and substantial provisions. This has had a negative impact, with a considerable number of banks experiencing losses in both 2023 and 2024. However, solvency indicators remain favorable and are above regulatory minimums. In addition, the deterioration process in the loan portfolio quality is stabilizing, and recovery indicators of credit growth are beginning to emerge. Notably, in recent months, we have observed positive real growth in housing loan balances.

III. Inflation Trends, Expectations, and Monetary Policy Caution

In terms of inflation, I must first highlight the strong downward trend of this indicator since March 2023, when it reached a maximum of 13.34%. Over the past 21 months, headline Consumer Price Index (CPI) inflation has fallen by more than eight percentage points to the 5.2% level reached last January.

Later, I will address the fact that headline CPI inflation has remained stable at 5.2% for three consecutive months, interrupting the downward trend of previous months. However, it should be positively noted that core inflation has continued to decline systematically, clearly responding to the contractionary monetary policy. The core inflation indicator most widely used indicator at the Bank (excluding food and items regulated by the government) fell from 10.5% in June 2023 to 5.15% in December 2024, and 5.02% in January 2025, according to the figures released last weekend by DANE.

The fact that headline inflation has not continued to decline in recent months, unlike core inflation, is entirely due to an upturn in food prices, which we expect to be temporary. Annual food inflation went from below 2.0% last October to 4.5% in January.

IV. Reasons for Caution

The significant reduction in inflation achieved over the past two years cannot and should not lead us to complacency or a relaxation of the cautions with which the Bank has managed monetary policy in the recent period. In this regard, three key messages should be highlighted:

First, inflation remains significantly above the 3.0% target set by *Banco de la República*, a target that, as I mentioned at the beginning of my intervention, is an essential part of the inflation target strategy with which the Board of the Bank has interpreted its constitutional mandate. In 2024, we completed four years with inflation above the target, making it particularly critical for the credibility of the Bank and its strategy to meet the target in 2025.

The second message, which reinforces the previous one, is that inflation has proven to be more persistent in Colombia than in other countries in the region. In fact, Colombia currently has the highest inflation rate among all countries with an inflation target strategy in the Americas, including advanced countries, such as the United States and Canada, and countries with emerging economies similar to ours, such as Mexico, Brazil, Chile, Perú, Uruguay, Paraguay, and Costa Rica. In these countries, inflation increased notably in 2021 and 2022, but all managed to bring it down to levels that are today lower than Colombia's and more in line with the targets set by the central banks. Three particularly noteworthy cases are Perú, Costa Rica, and Paraguay, where inflation rates already reached or fallen below their respective targets, which has opened the possibility for them to significantly lower their policy interest rates far below the current rate in our country.

There are several reasons to explain the strong persistence of inflation despite a contractionary monetary policy. Among them, I would like to highlight how difficult it has been to reduce services inflation, which in the Colombian case remained at a level of 6.8% last January, well above headline and core inflation. To a high degree, services inflation is pressured upwards by phenomena such as the system we have of rental indexation to the previous year's inflation and the annual minimum wage adjustment mechanism, which in the last four years has become particularly complex due to increases much higher than the observed inflation.

The third message regarding the cautious approach we must maintain in monetary policy relates to inflation expectations. In a context where inflation remains above target and is more persistent than desired, inflation expectations play a crucial role in policy decisions.

As of December 2023, and at all eight sessions of the Board of *Banco de la República* in which monetary policy decisions were scheduled to be made during 2024, a process of reducing policy interest rates was systematically carried out, completing 375 basis points, taking it from 13.25% to 9.5% in December 2024. This process was conducted cautiously, with 50 bps reductions between March and October. In December, the pace was slowed to 25 bps and in January it was deemed appropriate to pause while waiting for more information on the determinants of future inflation, expectations, and the elements of judgment required to define the magnitude and speed at which monetary policy could be eased without jeopardizing the fulfillment of the target.

Among the factors that led to greater caution in December and January, I would like to highlight the performance of inflation expectations. An indicator we closely monitor is Break-Even Inflation, calculated as the difference between the return at which the fixed-rate TES and inflation-linked TES (TES in UVR) are traded in the market at different terms. After making some technical adjustments for differences in liquidity and volatility premiums of the various securities, this indicator suggested last October that the expected inflation for the end of 2025 was remarkably close to 3.0%, fully aligned with the established target. In January 2025, the same indicator had risen to over 4.5%. Expectations reported by analysts in surveys conducted by *Banco de la República* and other institutions also increased between October and January, although to a lesser extent, and remain around 4.0%, still above the target.

Risks of higher inflation than expected a few months ago by the end of 2025 are partly linked to international phenomena, such as the potential for a global trade war driven by strong tariff increases by the U.S. This same outlook has made expectations of interest rate reductions by the Federal Reserve (FED) significantly more limited, and long-term global interest rates are currently higher than observed a year ago. In this context, during the last months of 2024, there was a significant depreciation of the currencies of emerging economies such as Colombia against the US dollar, with implications that could put upward pressure on inflation in our countries. Although this phenomenon has been partially reversed since the beginning of January, only time will give us greater clarity on its persistence over time.

Possibly related to the peso depreciation in the last months of 2024, the increase in tradable goods prices, as reflected in the Producer Price Index (PPI), has been significant. Last October, the annual growth rate of the PPI was only 1.6%, a figure that increased to 5.8% in December, although it slightly declined to 5.5% in January, perhaps reflecting the correction observed in the exchange rate.

Parallel to this, idiosyncratic factors have also impacted inflation expectations and the risk margins implicit in the interest rates of Colombian bonds abroad, making it necessary to reinforce a cautious approach. Among these factors, the most notable is that the fiscal accounts for 2024 showed a significantly larger deficit than anticipated, with a deficit of 6.8% of GDP, 1.2 pp higher than projected, which means that Colombia’s public debt levels are now at approximately 60% of GDP, considerably above the previous estimates of around 55% of GDP.

For 2025, the Financial Plan issued by the National Government last week projects a reduction in the deficit to 5.1% of GDP. Although this would imply a substantial improvement compared to 2024, concerns about fiscal sustainability persist not only because it is a higher deficit than expected when the Government Budget was presented, but because it is presented despite the fact that it represents a very strong growth in tax revenues, 17.4%, whose viability has generated concerns among several analysts. Moreover, even if these revenue projections were met, the government's net debt would remain above 60% of GDP at the end of 2025, a level similar to the all-time highs we reached during the COVID-19 crisis in 2020 and 2021 and clearly higher than the 55% of GDP that the Fiscal Rule Law considered sustainable and adopted as a reference anchor for that rule.

Besides the fiscal issue, among the factors that have recently affected inflation expectations, the magnitude of the minimum wage increase for 2025 stands out, which, if the adjustment in the transportation subsidy is included, implies an increase in costs for employers of 11%, more than 6 pp above the observed inflation and 8 pp above the inflation target. It is worth noting that this increase in the minimum wage also has a significant effect on the fiscal accounts, particularly due to its impact on pension payments of the average premium regime, which, in a high percentage, correspond to pensions of amounts equivalent to or close to the minimum wage.

Undoubtedly, recent developments create significant challenges for monetary policy and may make it more difficult and costly to achieve the inflation target. The decisions ahead will be complex. They are expected to be consistent with a path of interest rates that are falling, but probably at a slower pace than previously expected to maintain their consistency with the convergence of inflation towards its target. As we reiterate in all the Board's press releases, decisions will always be made with the available information, under the policy guidelines that I have tried to outline in this presentation.

V. The role of *Banco de la República* in the Administration of the Contributory Pillar Savings Fund of the Pension System

I wish to end this presentation commenting on the role that *Banco de la República* will play in the administration of the Contributory Pillar Savings Fund of the pension system, based on what was approved last year by the National Congress.

Law 2381 of 2024 defines a new Comprehensive Social Protection System for Old Age based on four pillars: solidarity, semi-contributory, contributory, and voluntary savings. In the contributory pillar, the pension contributions made by workers are divided between an average premium component and an individual savings component. The average premium component will be administered by Colpensiones and will receive the contributions of all workers corresponding to incomes from 1 to 2.3 smlmv. Since the contributions of these workers go partially to the individual savings component, the change implies a significant increase in the resources that Colpensiones will receive from the moment the reform comes into force. In the future, this situation will be reversed, because the payment of pensions by Colpensiones will require more resources than those demanded by the current system.

In other words, the reform will generate a temporary surplus of resources for Colpensiones, which will surely be insufficient to cover future pension obligations. The bill itself estimates that by 2070 the Contributory Pillar Savings Fund (FAPC in Spanish) will have been fully exhausted, with which the National Government will need to provide more resources to cover the corresponding deficit. The challenge of making the pension system sustainable in the long term will surely require adjustments in the parameters of the system, particularly in retirement ages and in the contribution percentages of affiliates. The challenge of moving in this direction is still latent and is not altered at all by the role of manager of financial resources that *Banco de la República* is going to fulfill.

The creation of the Contributory Pillar Savings Fund (FAPC) administered by *Banco de la República* is proposed in such a way that the Fund is assigned calibrated revenues so that current expenditure on pensions by the National Government and the aggregate savings of the economy remain unaffected.

The resources received by *Banco de la República* through the FAPC will be channeled to the capital market through professional managers to generate a return that will help the National Government cover its pension obligations in the future. The law establishes a Directing Committee that will act as the highest authority of the FAPC and will have three members of the National Government and four independent expert members appointed by the Board of Directors of *Banco de la República*.

In line with its constitutional role as the Government's fiscal agent, the Bank will act as the manager of the Fund under a responsibility of means rather than result. For this purpose, the Bank shall provide the appropriate technical and operational infrastructure, ensuring a strict separation between the Fund's resources and the Bank's own resources, both in budgetary and accounting terms, guided by principles of prudence and diligence, common in trusteeship mandates. In addition, in the design of the Fund's management scheme, the Bank will ensure that its management is totally separated from the management of international reserves and from the monetary, exchange rate and credit policy functions, the guidelines of which are defined by the Board of Directors. This is how the Savings and Stabilization

Fund (FAE in Spanish) currently operates, through which the Bank serves as the government's fiscal agent to manage resources originating from oil activities.

Regarding the resources to be administered in the Contributory Pillar Savings Fund, I would like to highlight that according to calculations by the Independent Fiscal Rule Committee (CARF in Spanish), the Fund's annual revenues would be close to 0.9% of GDP in the first years of operation and would reach 1.2% of GDP in 2051, the year from which they would progressively decline. Accordingly, at the peak assets under management would reach approximately 660 trillion pesos, equivalent to more than 35% of GDP. This is therefore an enormous responsibility, the proper functioning of which will have important implications for financial and capital markets. Preliminary estimates suggest that the Fund's monthly income as of 1 July would be in the order of 1.4 trillion pesos, which highlights the urgency of defining all the regulatory details as soon as possible so that the Bank can define the processes and the corresponding contracts for its proper operation.

In order to move forward in the structuring of the Fund, it is essential to have a regulatory framework that defines the composition of its Directing Committee, as well as the functions of that Committee and of the Bank as manager. The Bank has worked hand in hand with the Ministry of Finance and the Financial Regulation Unit (URF in Spanish) to outline a regulatory proposal that must be issued by the National Government. In this draft decree, a transition period has been proposed that will allow it to begin operating on 1 July, despite the lag that already exists in the regulations required to be able to form the FAPC’s Directing Committee, advance in preparing contracts with the delegated administrators, define the criteria to choose them and establish their investment guidelines.

We hope that the draft decree that was worked on intensively last year with the URF and the Ministry of Finance and which, we understand is currently under review by the Ministry of Labor, can be published as soon as possible for public comment. With its issuance, the process of preparation for a change of such depth as the one we have ahead of us can begin, for which we have less than five months. Without the prompt issuance of this decree, it would be impossible to define the essential elements to begin administering the Fund in its transition period.

No less important is the additional regulation that must be built by the National Government, among others, on the operation to define the Fund's income, the definition of the generational sub-account scheme, their respective investment policies and the decumulation phase. The prompt issuance of the corresponding decrees is absolutely essential for the Bank to be able to comply with the functions assigned to it by law within the established time frames. The Bank has offered and will continue to offer its full cooperation so that the actors involved work with the required speed, and in a joint and coordinated manner, to achieve an adequate implementation of the new pension system in relation to the creation and entry into operation of the Contributory Pillar Savings Fund (FAPC).

Thank you.