

Monetary Policy in Colombia

Trade offs and policy dilemmas

Jorge Toro

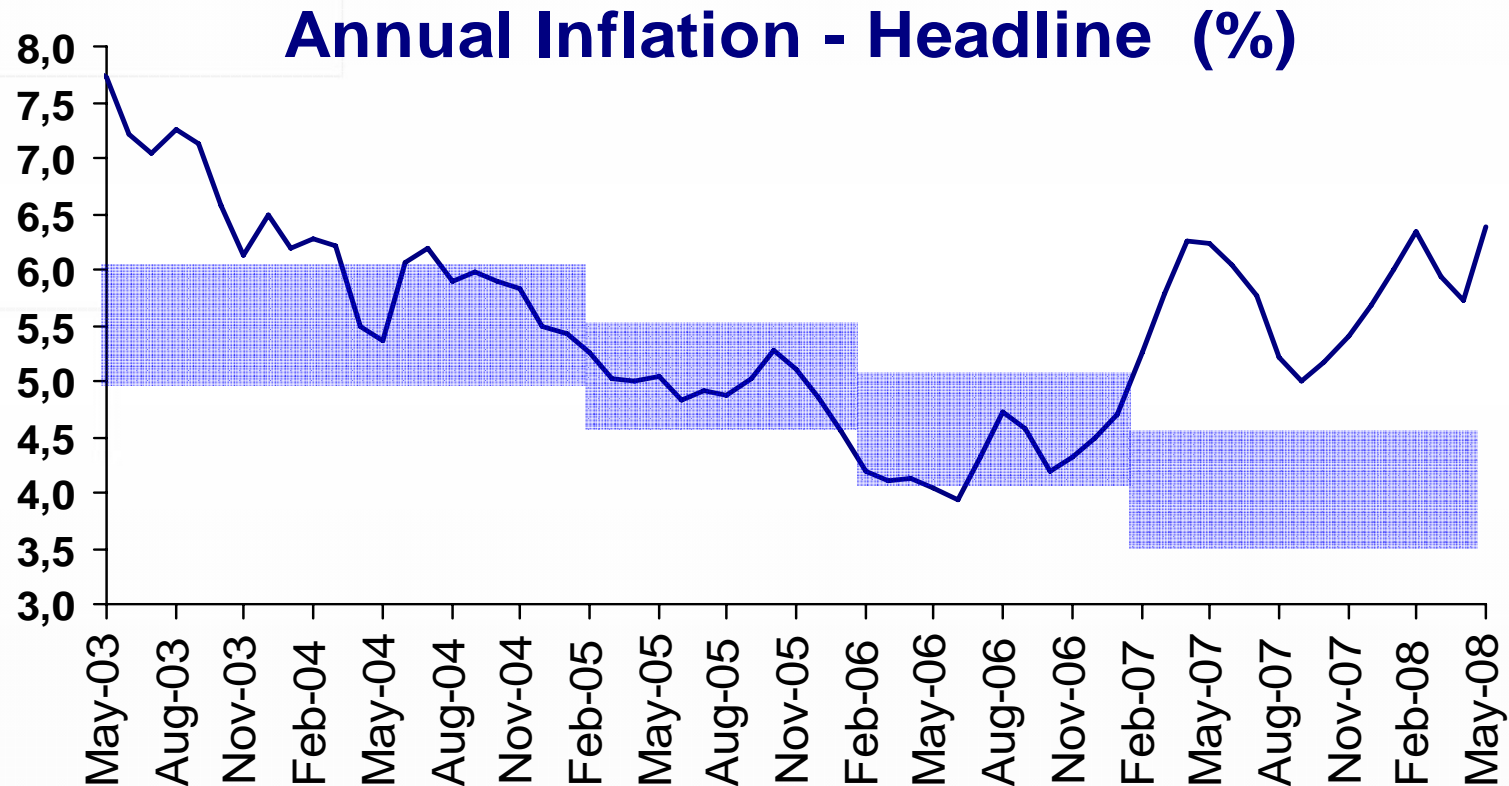
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Lima, June 16, 2008

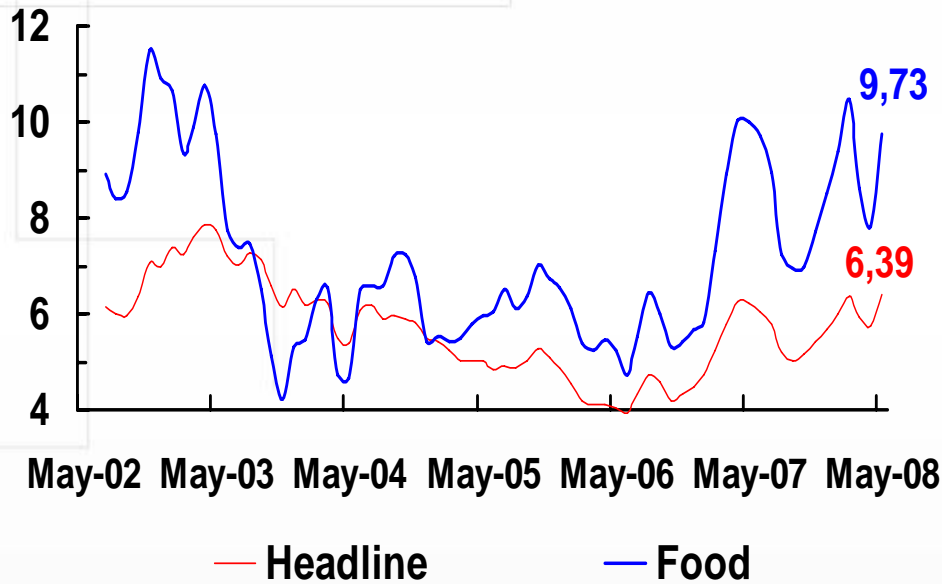


By the last quarter of 2006 inflationary pressures started to show up. The inflation target was missed in 2007 and current inflation continues well above the target range.

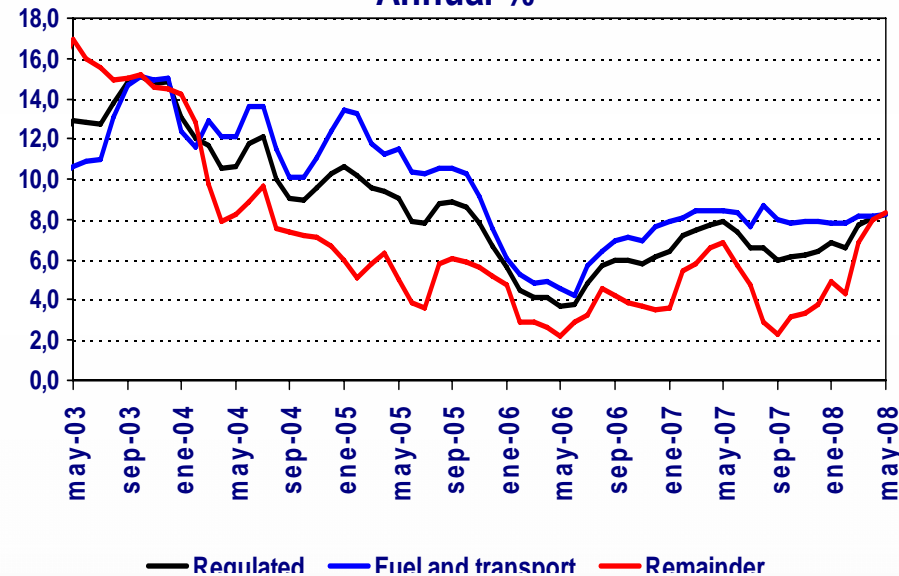


Most of inflationary pressures are explained by an increase in food prices, with contribution to total inflation in 2007 of 46%. Oil prices, has also put pressure on inflation

Headline Inflation and Food Inflation (%)

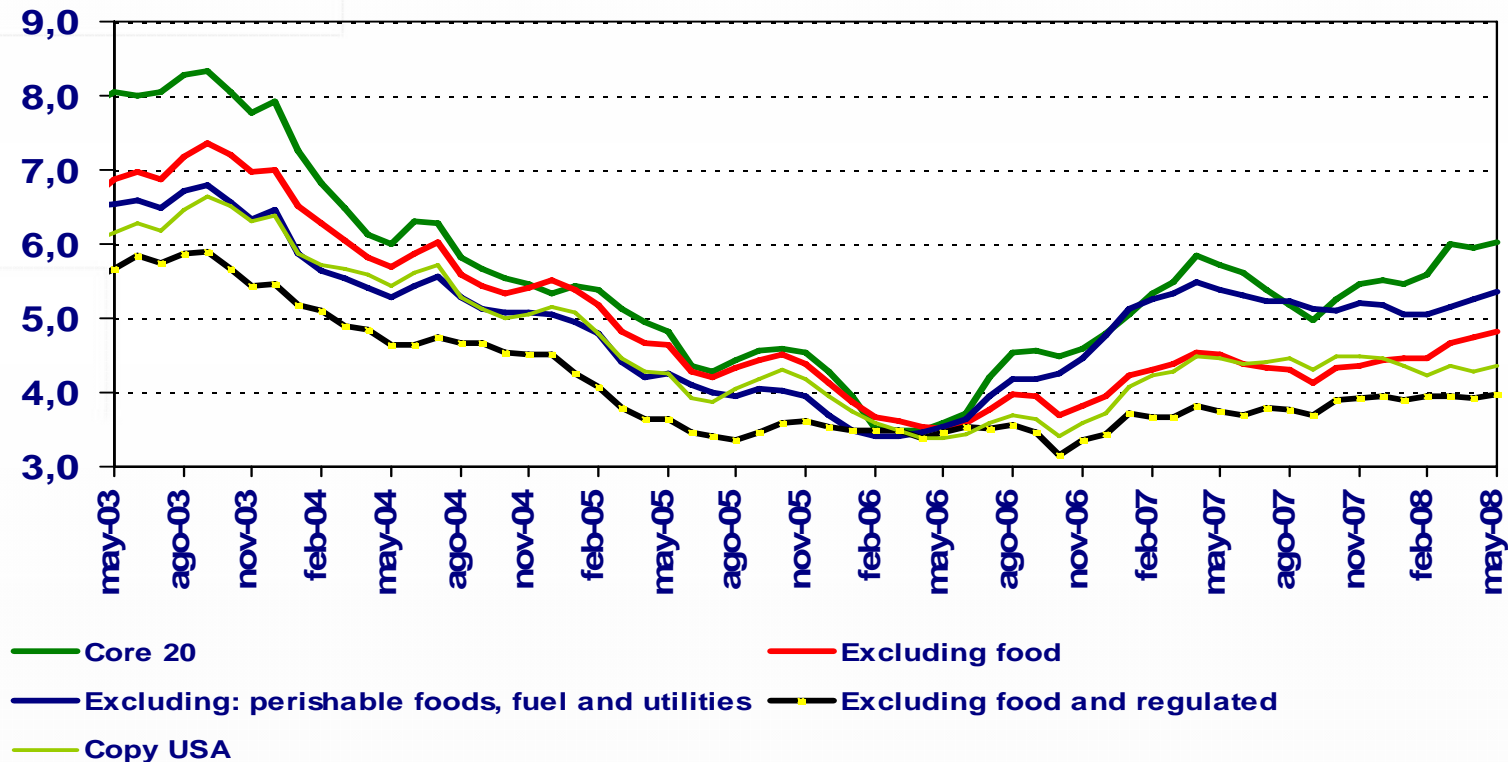


Regulated Inflation Annual %



Nonetheless, there are more than supply shocks in the explanation of inflation. In fact, different measures of core inflation show an upward trend. Hence, excess demand has also played an important role.

Measures of core inflation



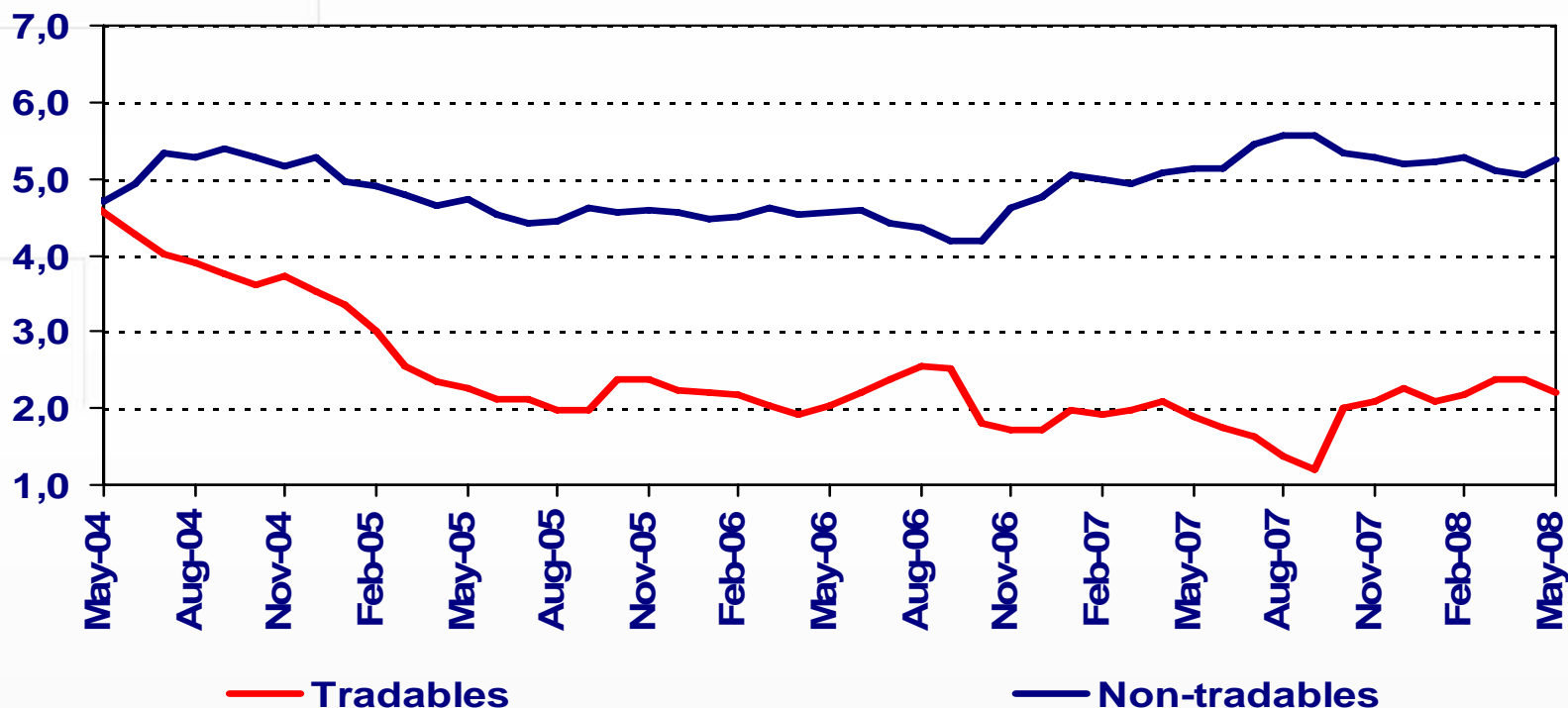
Source: DANE and Banco de la República.



Inflation of tradable goods (excluding food and regulated) remains positive, hovering around 2%, despite the sharp appreciation of the peso (11.8% in the last 12 months).

Non-tradable goods inflation is stagnant above 5%

**Inflation Tradable and Non-Tradable
Excluding Food and Regulated (Annual %)**

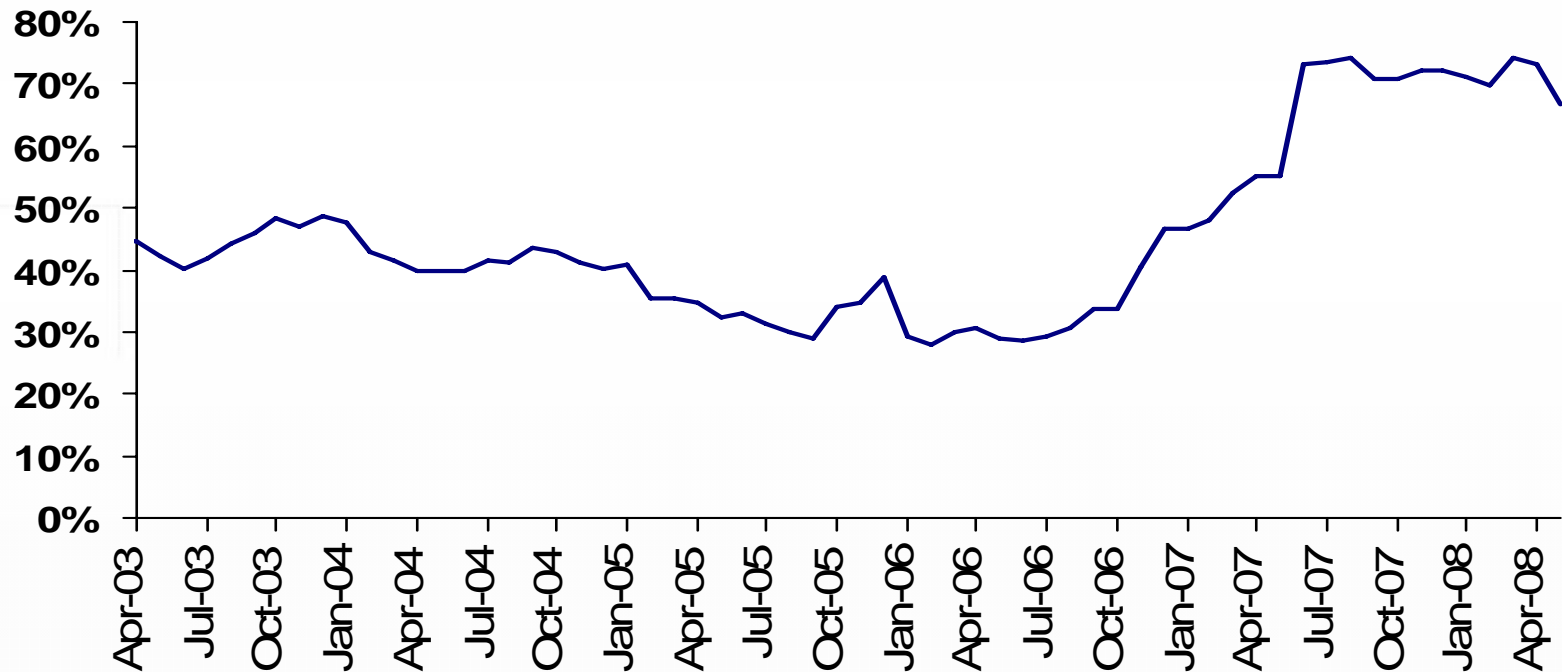


Source: DANE and Banco de la República.



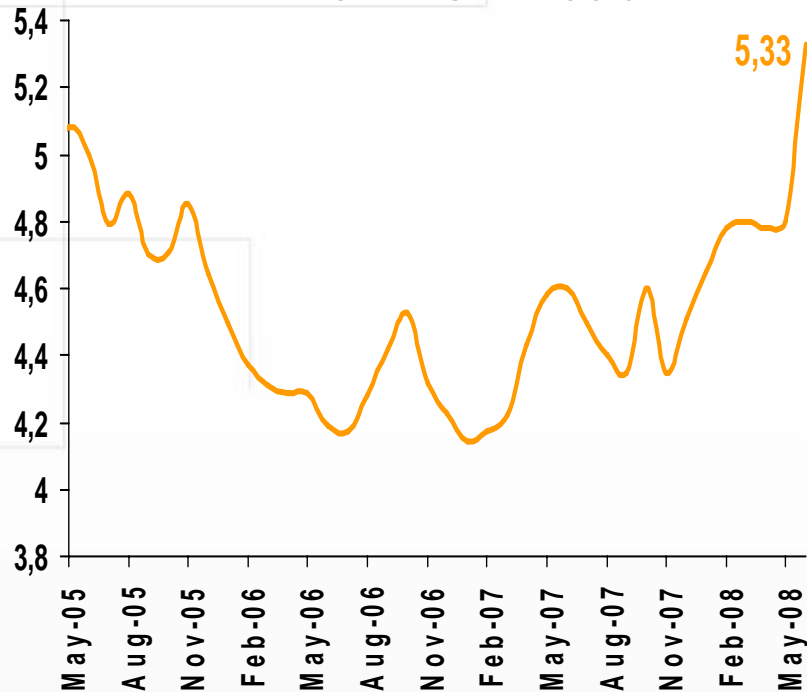
The diffusion indicator, that is, the weighted percentage of items of the consumer's basket whose annual inflation is above the mid-point target range, reaches 70 percent

Difussion Indicator

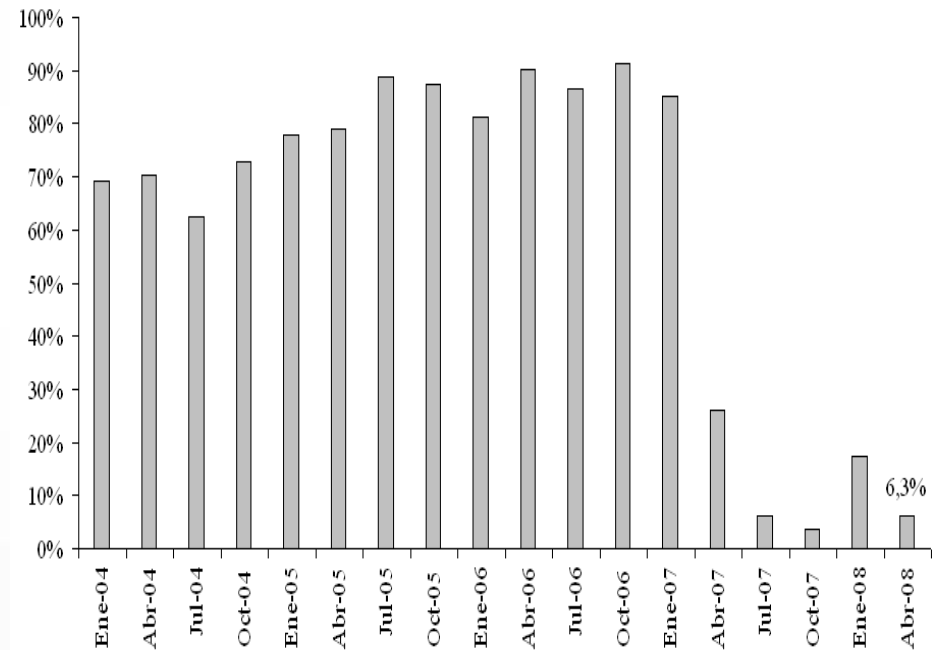


The rise in inflation and its diffusion to many goods, have increased inflation expectations and have reduced the credibility on the inflation target

Inflation Expectations 12 Months Ahead



Credibility on the Inflation Target (Percentage)



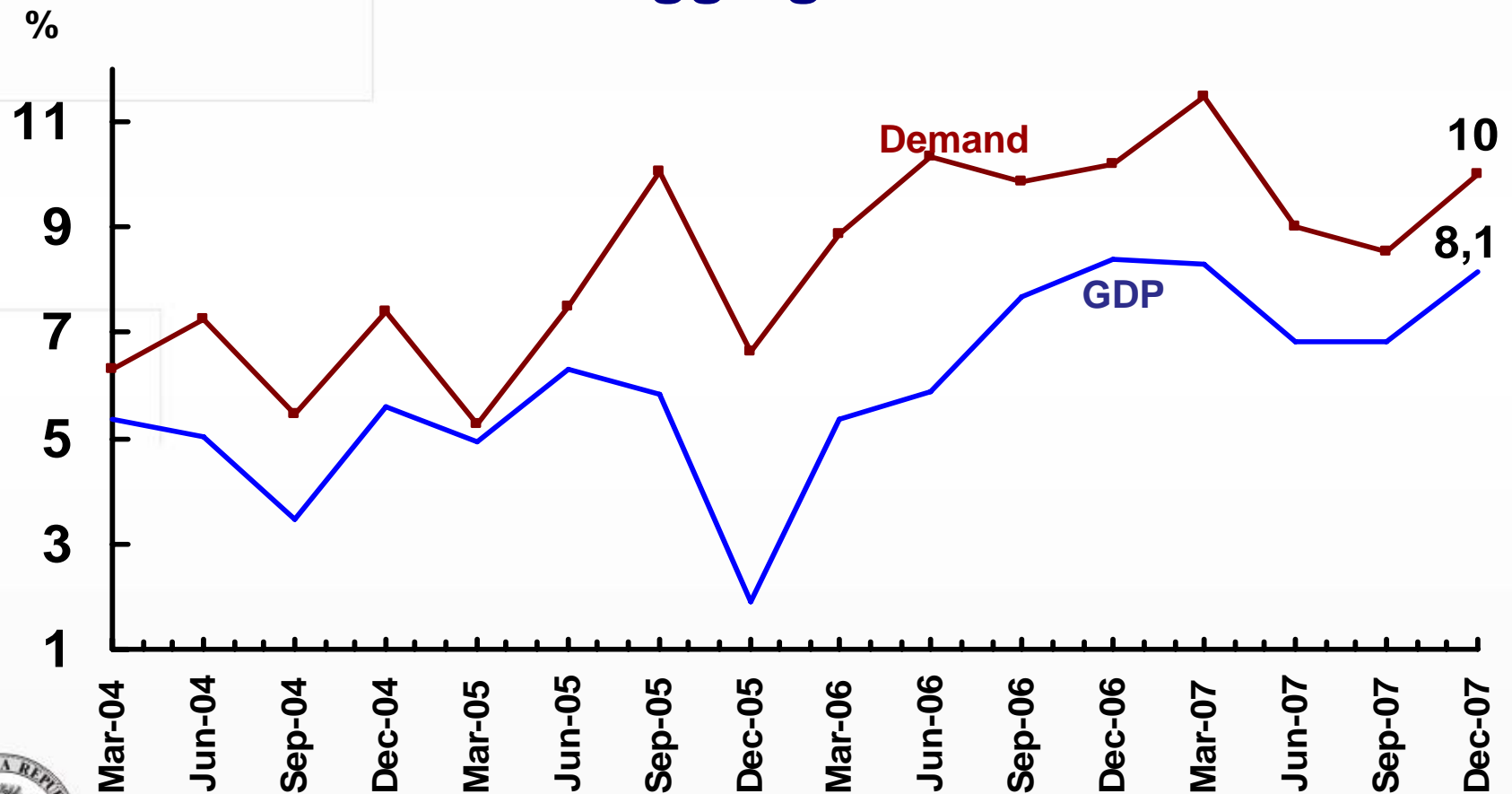
Source: SGEE, Departamento Técnico y de Información Económica, Sección de Estadística.



Source: Banco de la República.

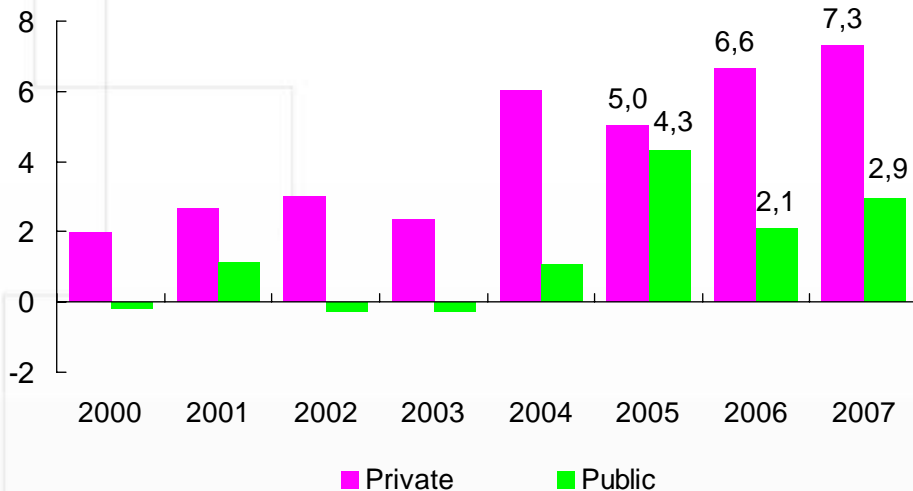
Inflation accelerated in a context of rapid economic growth, supported by a vigorous demand.

GDP vs Aggregate Demand

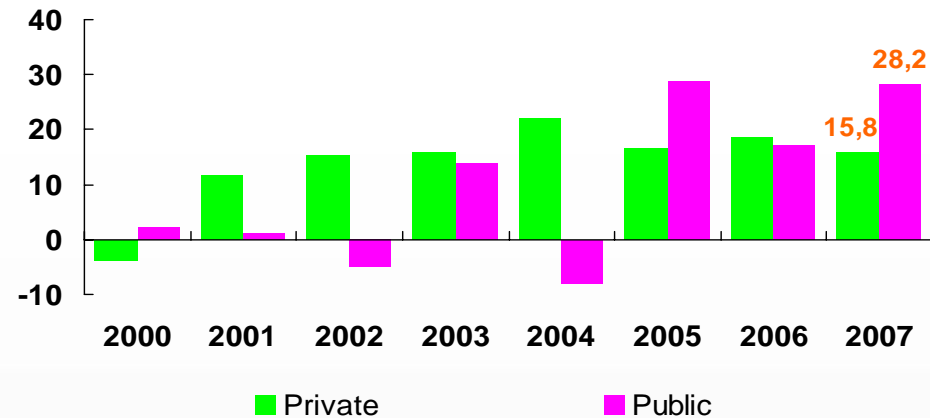


Expansion of aggregate demand is explained by a strong investment and consumption growth, associated with a rise of market confidence

Consumption Growth (%)

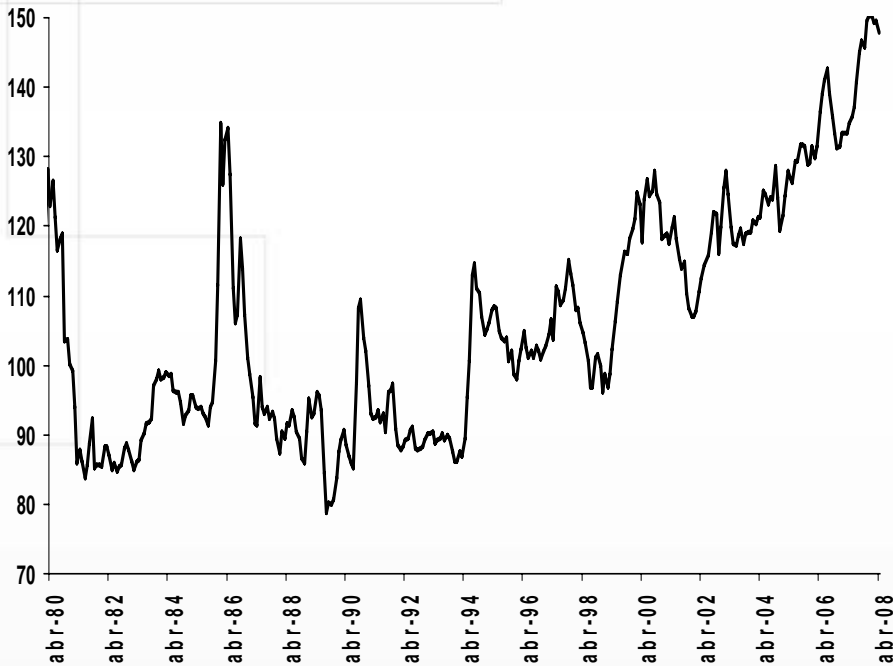


Investment Growth (%)

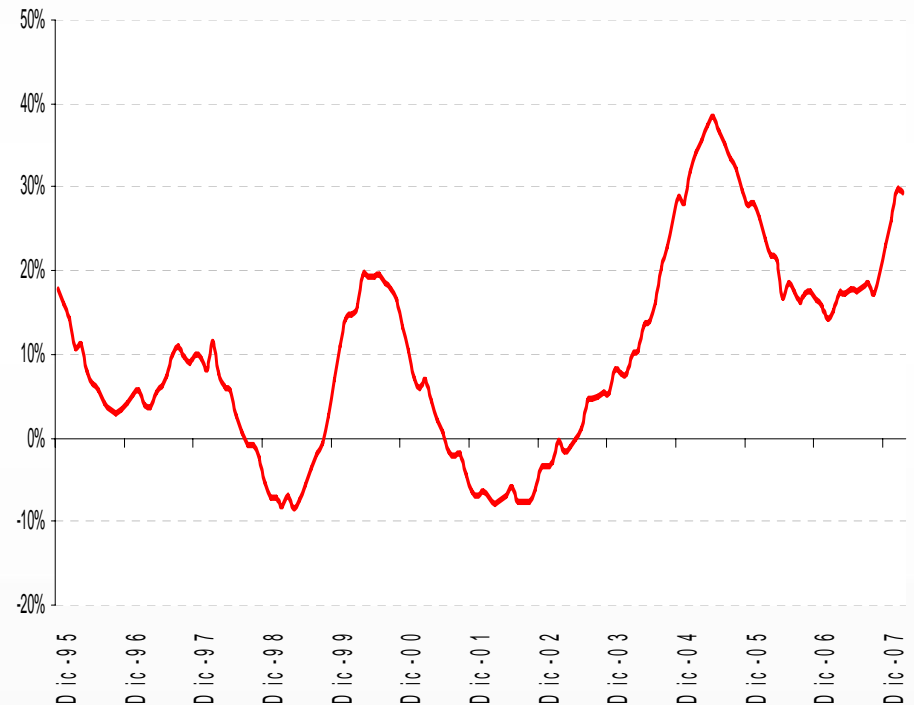


In addition, favorable terms of trade induced a rapid exports growth

Terms of Trade
1994 = 100

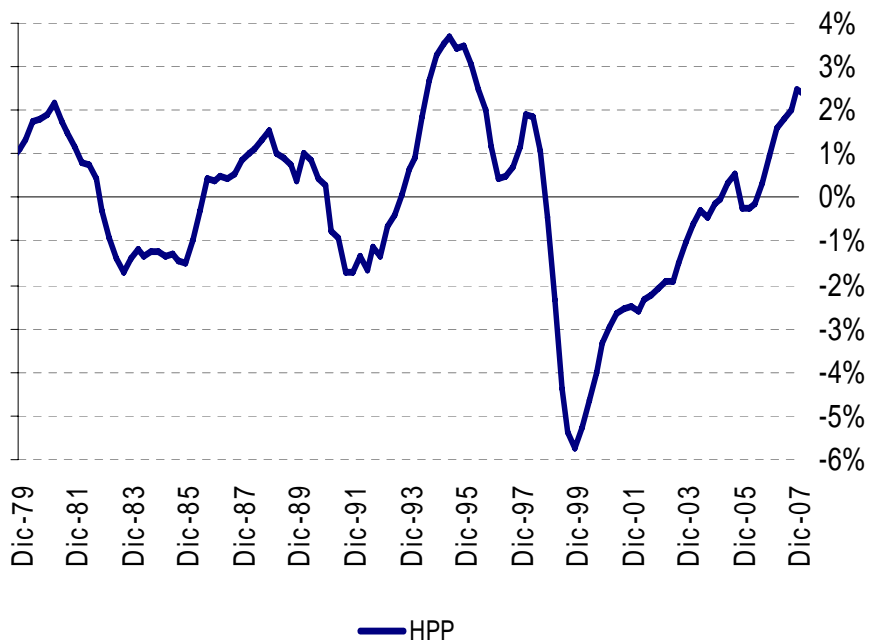


Exports Growth - Annual Variation
(12 Months Cumulative)

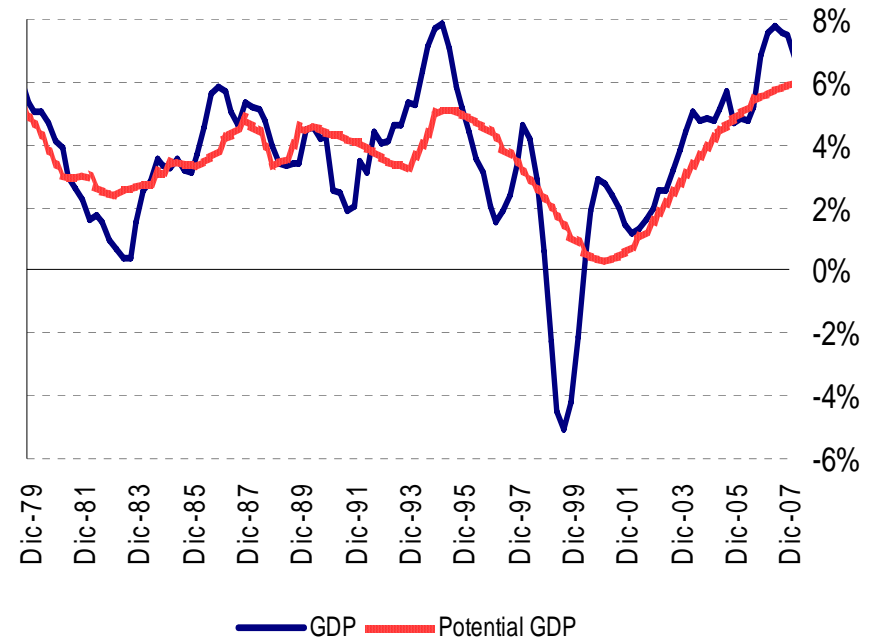


Strong demand resulted in an increasingly positive output gap, despite a rise of potential GDP. Output gap is currently estimated in a range of [2.0 - 2.5] percent.

Output Gap

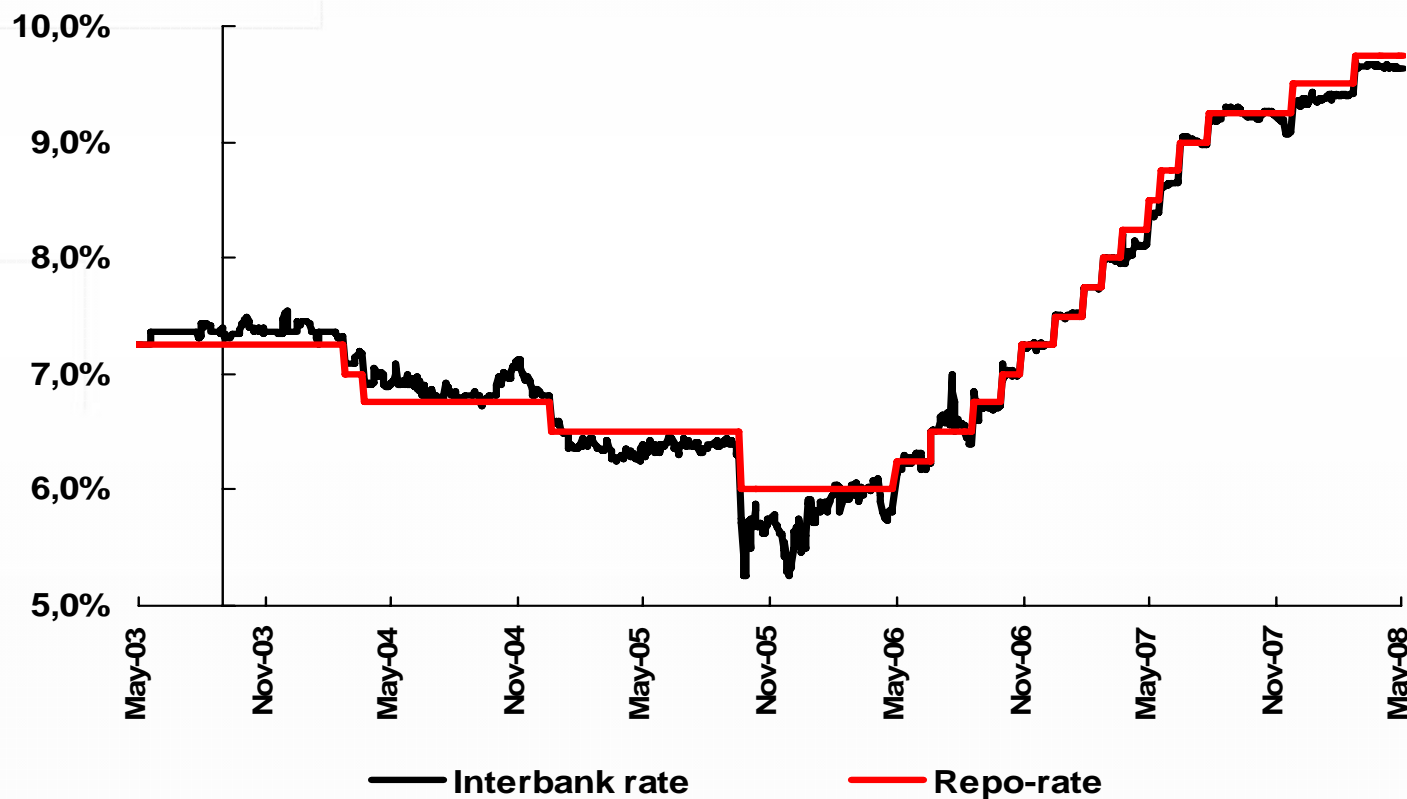


GDP and Potential GDP



In a context of rapid growth and inflationary pressures, the central bank decided in April 2006, to start a gradual raise of interest rates. From an initial level of 6%, interest rates have been increased to 9.75%.

Interbank rate and Central Bank Rate



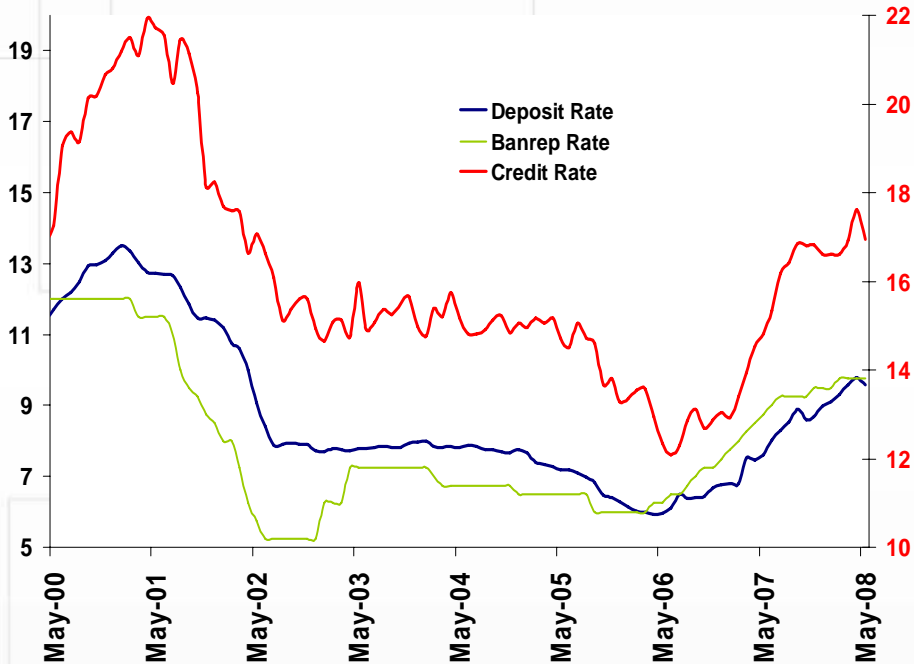
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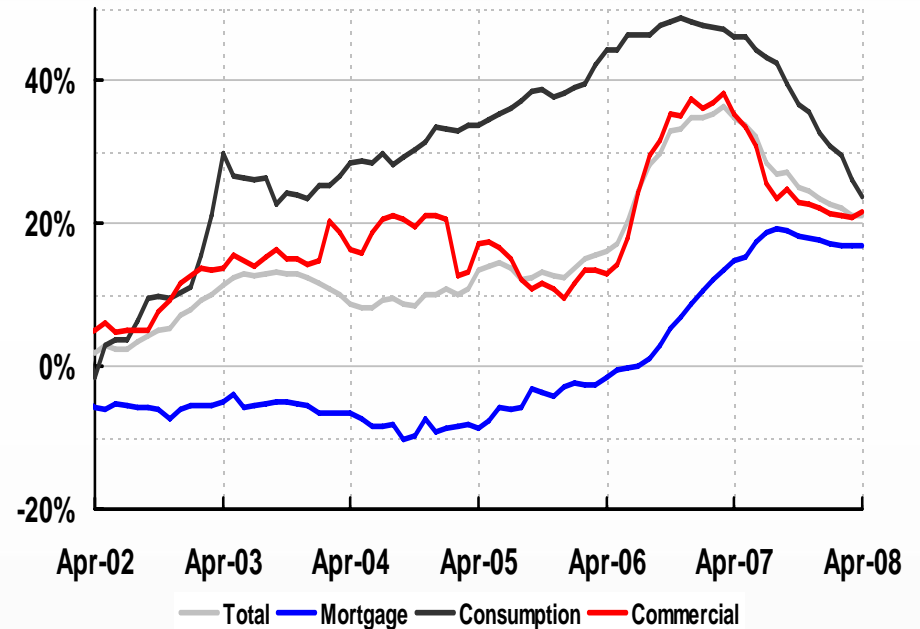
jechavso, 12/03/2007

The rise in the central bank rate was eventually reflected in higher of market rates and in a slowdown of credit growth

Nominal Rates (%)

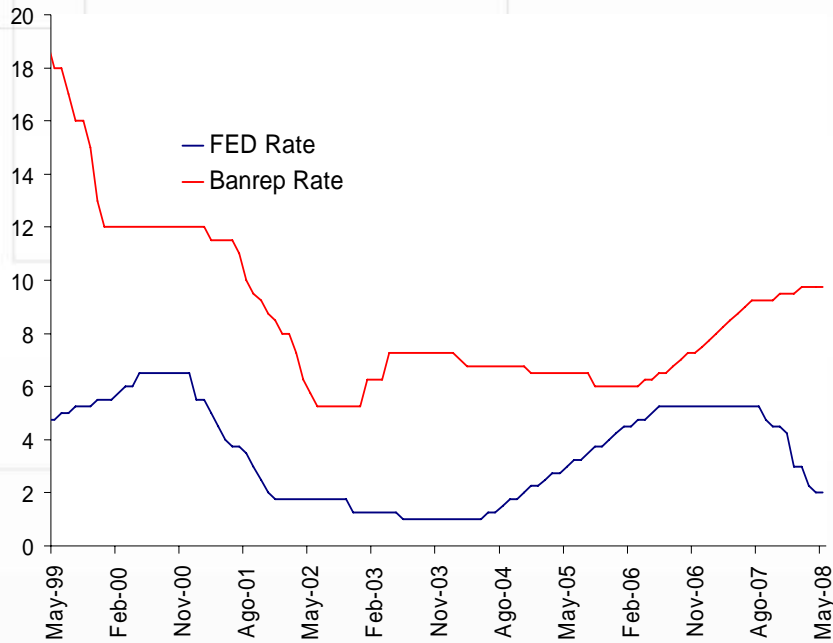


Credit Growth (Annual %)

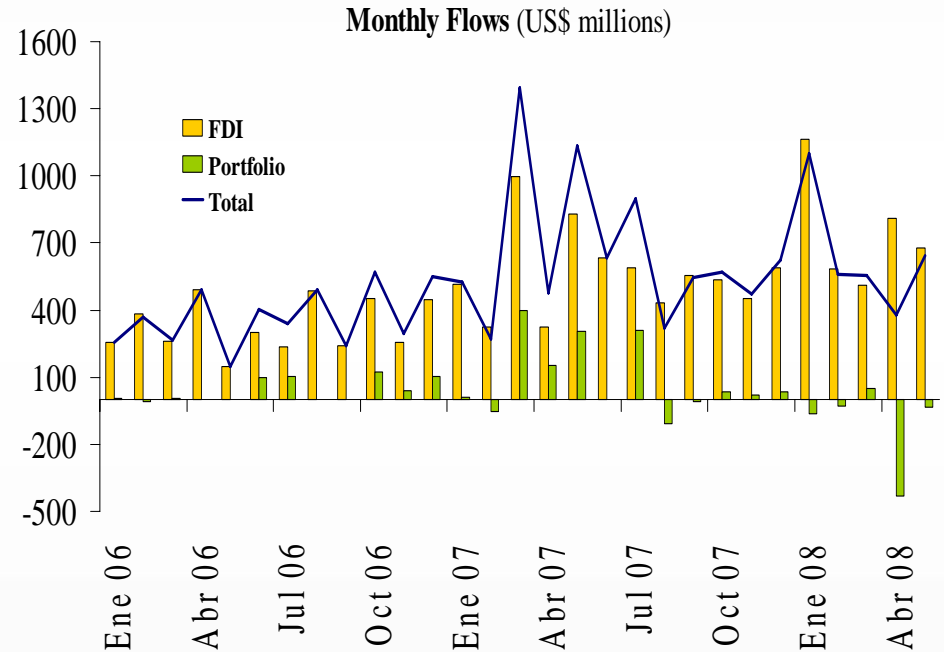


At the same time, higher interest rates widened the interest rate differential. Nonetheless, portfolio flows were discouraged by capital controls. Most capital inflows are FDI.

Central Bank Interest Rates



Net Capital Flows - Colombia

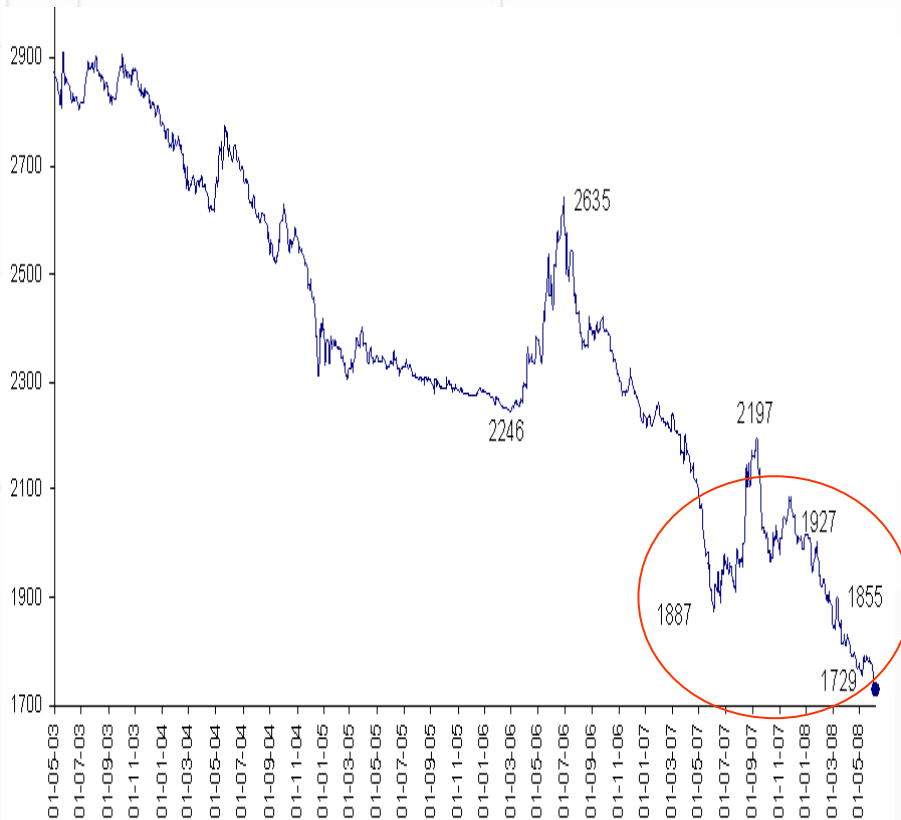


Source : Banco de la República



Despite active intervention in the foreign exchange market, appreciation of the Colombian peso has turned unstoppable.

Nominal Exchange Rate

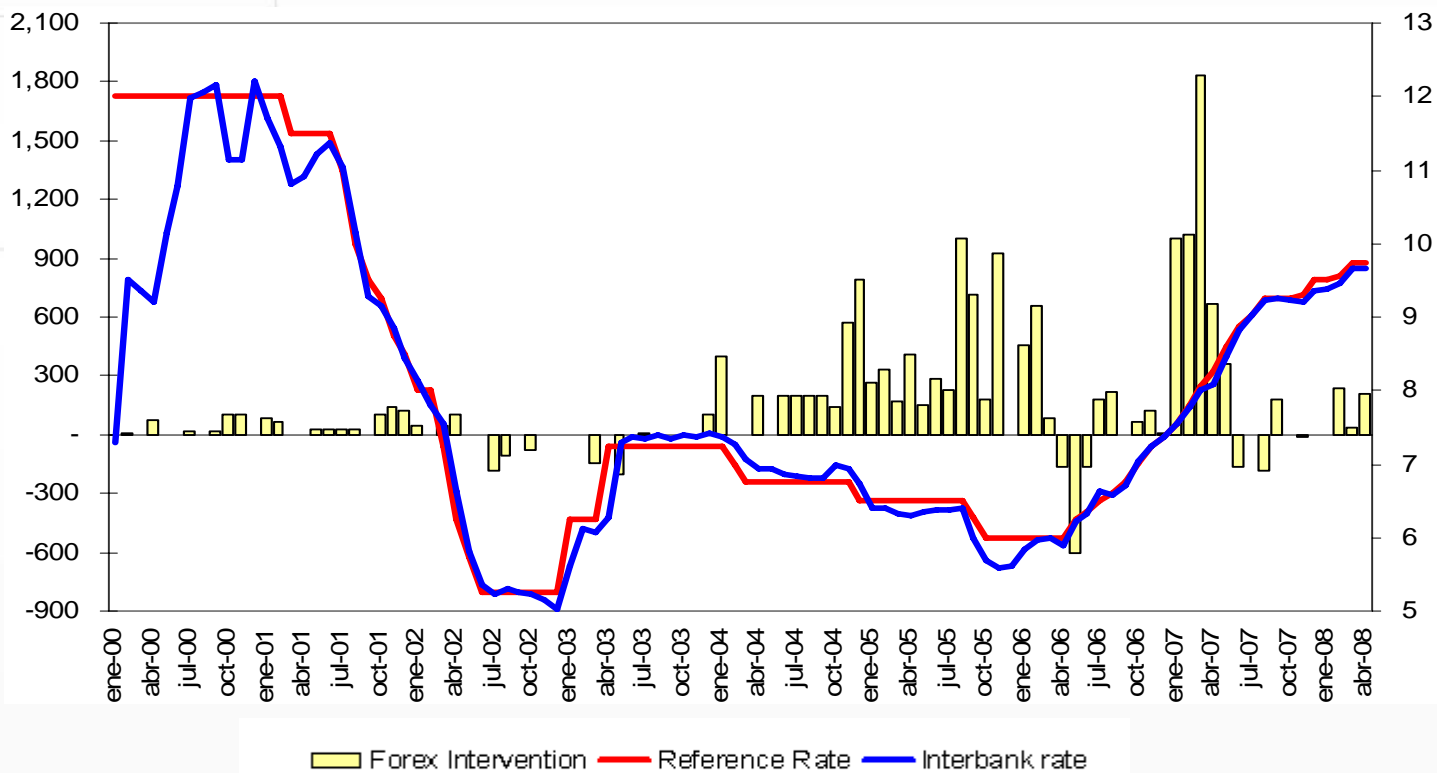


LATAM	Changes in Exchange Rates Against the US\$			
	Last Month	Year to Date	Year to Year	Last 3 Years
Colombia	-4,27%	-15,52%	-11,80%	-27,24%
Brasil	-1,48%	-7,86%	-16,73%	-32,93%
México	-0,92%	-4,79%	-5,71%	-4,28%
Argentina	-3,62%	-3,10%	-0,69%	6,03%
Perú	5,28%	-2,84%	-8,15%	-10,42%
Uruguay	-2,43%	-9,64%	-18,14%	-18,53%
Chile	6,43%	-0,28%	-6,32%	-15,80%

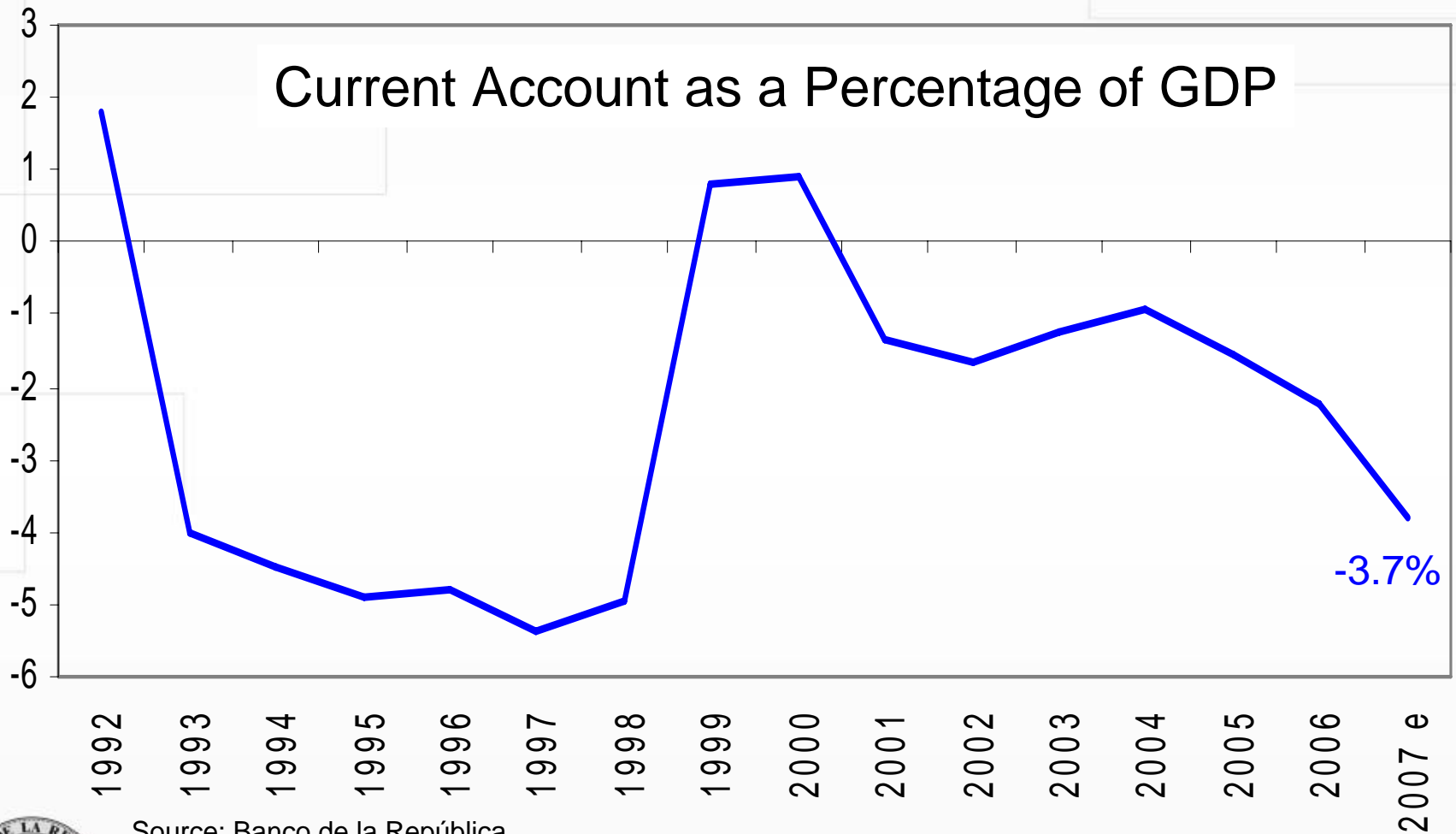


Ineffectiveness of Forex intervention was partly due to conflicting signals provided by a contractionary monetary policy and an expansionary intervention policy. The weakening dollar added pressure on the peso.

Intervention in the Exchange Market Central Bank Rate and Interbank rate



Rapid economic growth and appreciation of the peso have resulted in an increasingly current account deficit.



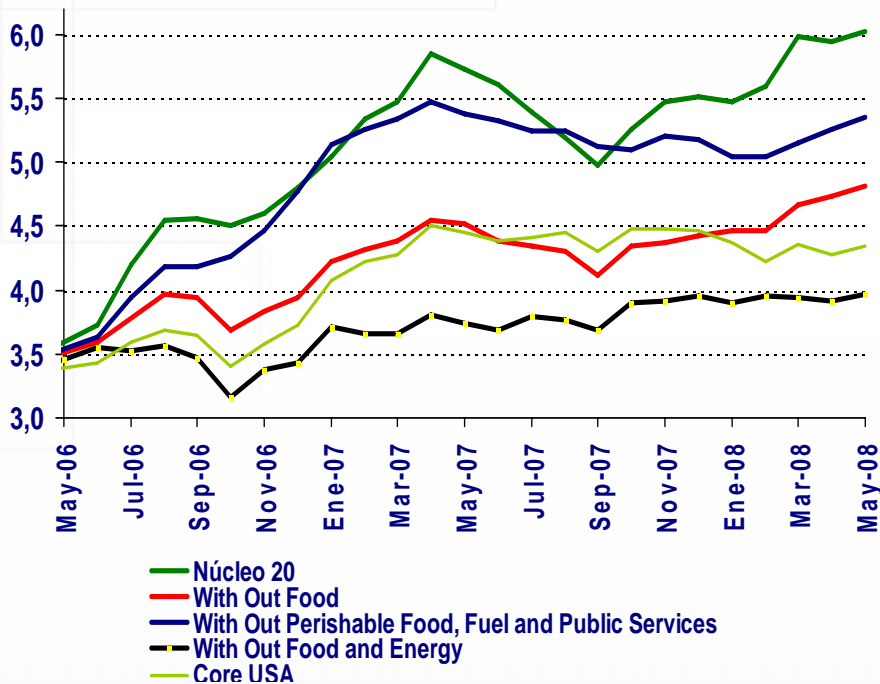
Source: Banco de la República



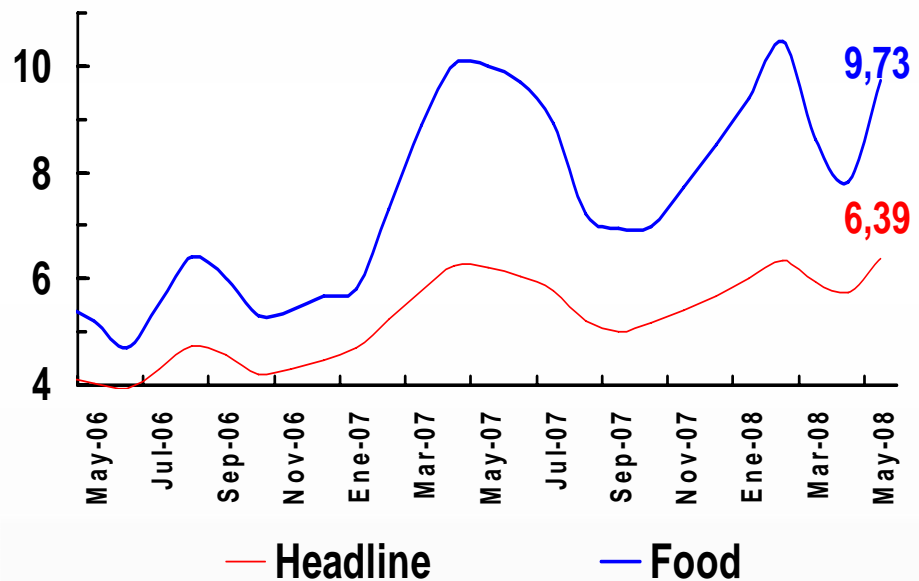
Despite a firm contractionary monetary policy, inflationary pressures remains strong

UC1

Core Inflation Indicators



Headline Inflation and Food Inflation (%)

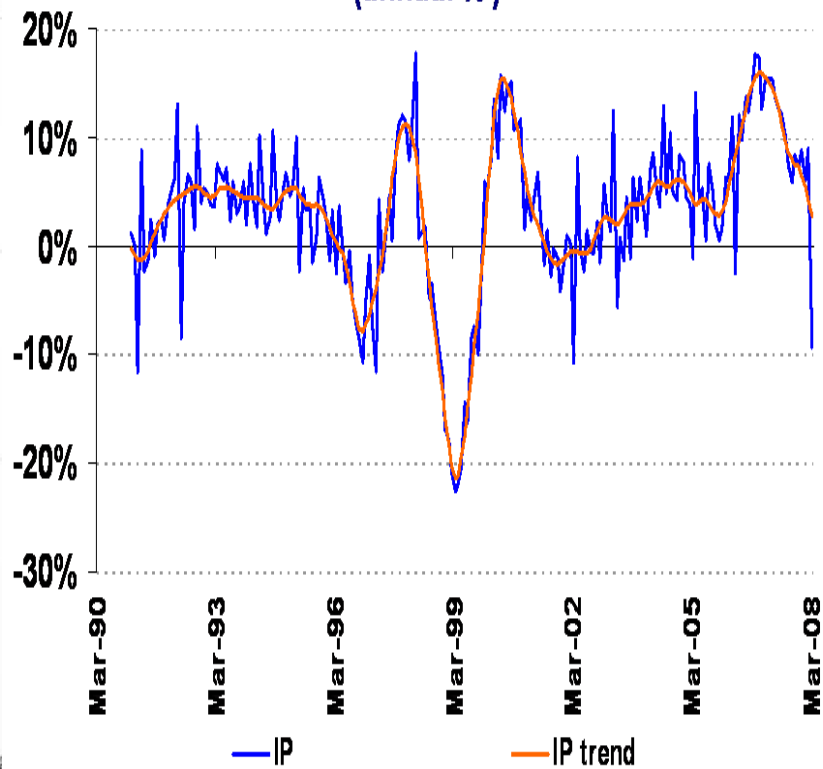


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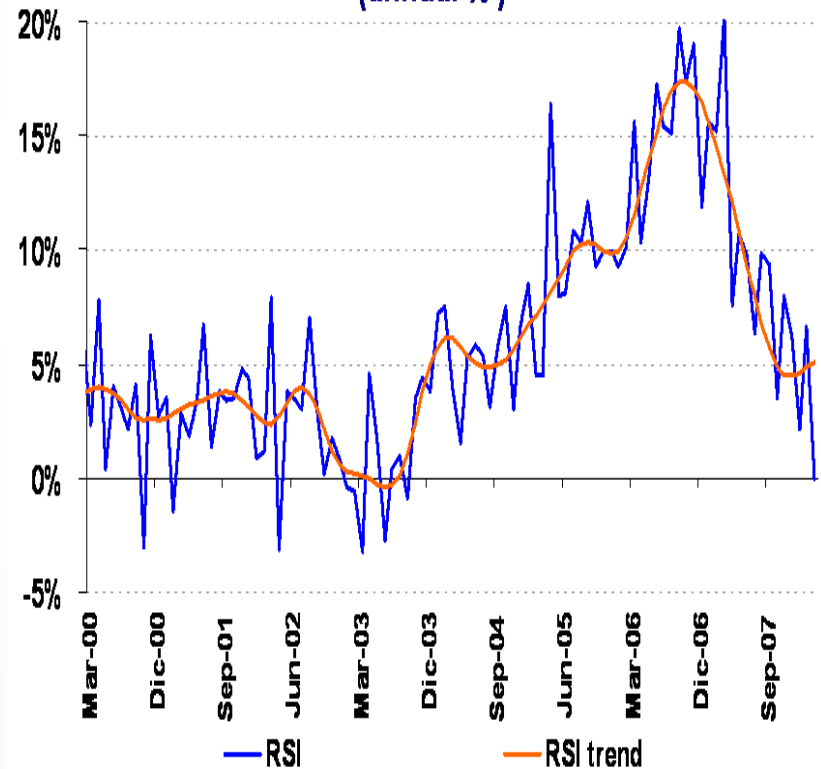
Dr. Toro, en esta gráfica usé los dos últimos años, en lugar del último año, porque en este último casi no se observa variación.
Usuario Computacional, 06/12/2008

At the same time, there are clear symptoms of a recent slowdown of economic activity, while appreciation of the peso is turning more acute

Industrial Production Index
(annual %)

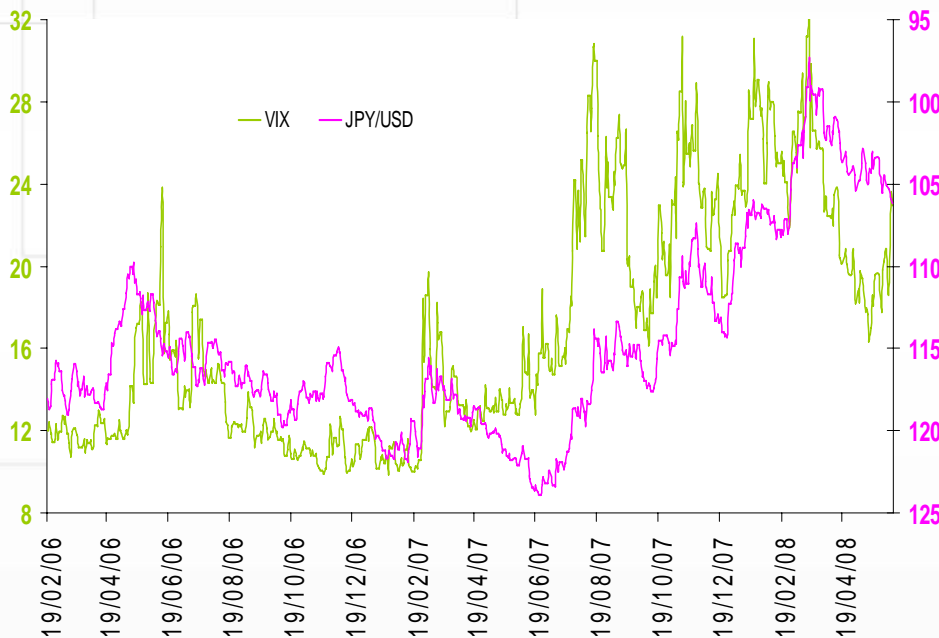


Retail Sales Index
(annual %)

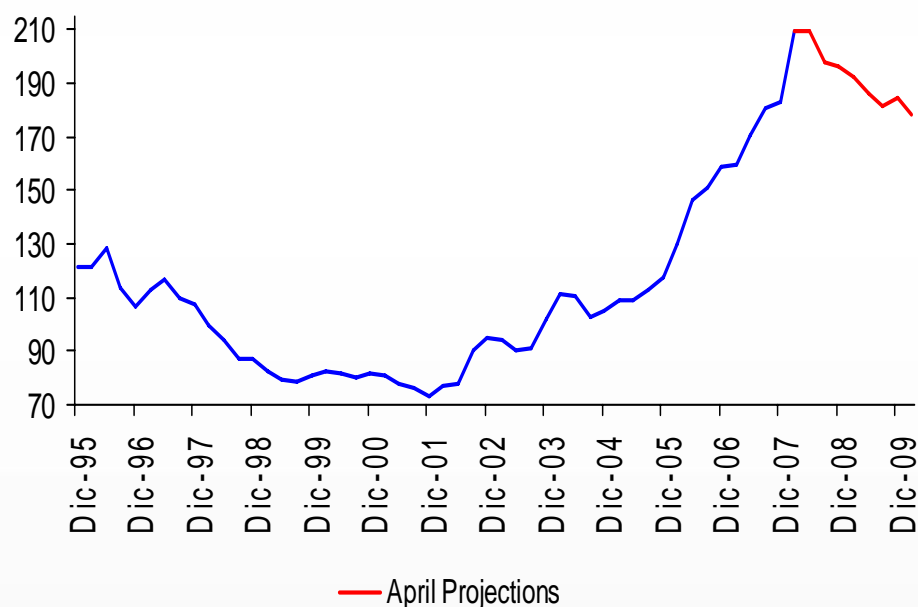


Uncertainty on the evolution of the world economy, and on its impact on emerging economies, makes particularly difficult at this juncture to assess the right direction of monetary policy.

International Risk Aversion



Commodities With Out Oil - Price Index



Source: EIU



In these circumstances, monetary authorities, both in Colombia, and in many other emerging economies, face challenging dilemmas:

1. Rising interest rates could exacerbate appreciation, but might also be required to tame inflationary pressures
2. Rising interest rates might be deemed indispensable to contain inflationary pressures, but entails the risk of inducing an excessive contraction of economic activity



The dilemma between relaxing or continue tightening could only be solved with more information, as time goes by, but postponing necessary decisions could threaten economic stability.

This is a hard time for policymakers

