Questions and answers regarding the decision from the Central Bank of Colombia

What measures did the Board of Directors (BDBR) take and why?

1. New currency hedging arrangements

The COVID-19 pandemic and the collapse of international oil prices have infused global financial markets with significant volatility. International securities markets have registered substantial losses as investors seek refuge in safe assets (such as U.S. treasury bonds) and look to get riskier securities off their books, including those of emerging market economies.

In Colombia, this has resulted in a significant rise in the price of the dollar and large increases in interest rates on government bonds. It has also created unease in local financial markets.

The Central Bank of Colombia seeks to maintain low, stable inflation and avoid extreme fluctuations in economic activity (output and employment).

To do that, the Bank sets the short-term interest rate (the cost of money) and requires exchange rate flexibility in light of changes in domestic and international economic conditions. Without this flexibility, the Bank would face difficulty in setting the interest rate to achieve its objectives.

It is for this reason that the Bank allows for adjustments in the exchange rate resulting from strong variations in oil prices and international financial market flows.

Nevertheless, when fluctuations in the exchange rate and the prices of other financial products are very significant, increased uncertainty can lead to disorderly market behavior, in which buyers and sellers' fears exert undue influence.

To prevent this type of situation from occurring in the dollar market, today the BDBR announced the provision of a new hedging instrument to allow market participants to hedge the risk of an overly significant depreciation of the peso.

How will this instrument work?

The instrument being provided is called a Non-Delivery Forward (NDF), and consists of the Central Bank of Colombia selling dollars at a one-month horizon using an auction-determined exchange rate. If, at the end of the month, the actual exchange rate is higher than the auction rate, the Central Bank of Colombia will pay the buyer the difference. If the reverse is true, the buyer will pay the Bank the difference.

In this way, market participants with dollar debt, or who need to make payments in dollars, will be able to guarantee the price of the dollars they need, reducing uncertainty.

Reduced uncertainty will help calm market participants' fears and prevent excessive market upheaval.

How much will be auctioned using this instrument?

The Bank will auction USD $1 billion of these instruments.

This is NOT intended to fix or set a ceiling on the price of the dollar, but rather to calm market participants and prevent the price from being determined under conditions of pronounced market fears.

The price of the dollar will continue to fluctuate according to its fundamental determinants (oil prices, domestic and international exchange rates, sovereign risk premiums, etc.).

2. Expanded liquidity auctions and a wider range of securities accepted by the Bank.

What is this decision intended to achieve?

In situations of significant financial turbulence, such as the present one, it is important to guarantee that financial intermediaries are able to access sufficient liquidity to meet their obligations. This allows for payments into the economy to continue without interruption or disturbance.

The Central Bank of Colombia guarantees the sufficient provision of liquidity in normal times. In periods of high turbulence, this is necessary to reinforce.

For that reason, the BDBR decided to increase the repurchase agreement operations, or repos, with which the Bank normally meets the Colombian economy's liquidity needs. These will rise from 9 trillion Colombian pesos on March 9, 2020 to 17 trillion pesos on March 13, 2020.

Not only will the amount of total liquidity available increase, but the types of securities accepted as guarantee for that liquidity will also be broadened. The Bank traditionally accepts public securities, but following today's decisions will also accept private securities with good credit ratings. Of the 17 trillion pesos of the expanded repos previously mentioned, 5 trillion will be offered under these conditions.

Who will benefit most from these liquidity facilities?

These measures will expand total liquidity available and broaden the types of securities used to back it. But they will also allow financial intermediaries who traditionally do not have access to some of the Bank's liquidity facilities to access them, starting today.

Specifically, brokerage firms, trusts and investment management companies, which until now have only been able to access certain mechanisms (intraday repo convertible to overnight repo), will be able to do so at term liquidity repo auctions (1, 7, 14 and 30 days) using private securities with good credit ratings as guarantee.