

THE INFLATION TARGETING STRATEGY IN COLOMBIA

OBJECTIVES

Monetary policy in Colombia is governed by an inflation-targeting scheme aimed essentially at achieving low rates of inflation and fostering stability in output growth around its long-term trend. Accordingly, monetary policy combines the aim of price stability with the objectives of maximum sustainable growth in output and employment, thereby fulfilling its constitutional mandate and contributing to the population's well-being.

HORIZON AND IMPLEMENTATION

The Board of Directors of the Banco de la República sets quantitative inflation targets for the current and the following year. The Board's policy actions are designed to meet each year's target and bring inflation down to around 3% in the long run. The targeted inflation measure is annual change in the consumer price index (CPI).

DECISION-MAKING PROCESS

Monetary-policy decisions are based on analysis of the current state of the economy and the outlook for it, and on evaluation of the inflation forecast in relation to the set targets. If the evaluation suggests, with a sufficient degree of confidence, that under prevailing monetary-policy conditions inflation will depart from target within the policy's operating time horizon and do so without being driven by transitory shocks, the Board will proceed to modify its policy stance, mainly by changing intervention rates, that is, the interest rates on the Bank's short-term liquidity operations.

COMMUNICATION AND TRANSPARENCY

Monitory-policy decisions are announced immediately after the Board's monthly meeting, in a press release posted on the Bank's website: www.banrep.gov.co.

Quarterly *Inflation Reports* provide transparency on the Board's decisions and help to make monitory policy better understood and more credible. Specifically, the *Inflation Reports'* objectives are: i) to communicate to the public the views of the Bank's Board of Directors and Technical Division about recent and expected movements in inflation and factors determining inflation in the short and medium term; ii) to explain the implications of those factors for monetary-policy management in the context of inflation targeting; iii) to explain the context and analysis underpinning monetary-policy decisions during the quarter; and iv) providing information that helps economic agents to form expectations about the future course of inflation and output growth

ASSESSMENT OF INFLATION SITUATION AND POLICY DECISIONS

POLICY DECISIONS IN FOURTH-QUARTER 2007

The Banco de la República's Board of Directors started to raise the benchmark interest rates in April 2006 from low real levels, in response to inflationary pressures that may have come from aggregate demand running above long-term sustainable levels. Although the 2006 inflation target was met, in 2007 the Board, taking into account inflation and economic-growth projections, raised the intervention interest rate seven times. Information available over the year confirmed the presence of inflationary pressures that jeopardized achieving the aim of price stability.

In 2007, annualized inflation peaked in April (6.26%) but decreased over the following five months until September (5.01%), then it went up again in October (5.16%) and kept on rising to the end of the year. In the last three months of 2007, the different measures of core inflation moderated their upward trend but remained high, indicating that excess demand, though abated, continued to exist.

Economic-growth figures for the first three quarters of 2007 overshot forecasts by local and international analysts and also projections by the Bank's technical team. Early data on fourth-quarter economic activity in sectors associated with industry, commerce and construction, on the supply side, and Fedesarrollo's consumer-survey findings, on the demand side, revealed first signs of a slowdown. Yet, aggregate demand continued to grow apace.

Job creation expanded considerably faster in the final months of 2007, lowering unemployment to 9.4% in November, compared with 11% a year earlier. Despite a slowdown in some types of credit, real annual increase in the loan portfolio and real growth rates of financial liabilities continued to far outpace GDP growth.

Hence, in a setting characterized by strong growth in aggregate demand and credit, by high capacity utilization, higher inflation expectations, and an international context in which the latest news pointed to a moderate slowdown in the US economy, the Board of Directors at their meeting on November 23 decided

unanimously to raise intervention rates by 25 basis points, from 9.25% to 9.50%. This decision was further intended to anchor inflation expectations and enhance credibility in meeting the 2008 inflation target, left unchanged at 3.5%-4.5%.

In December 2007, available information continued to reflect positive growth in the economy. But mounting uncertainty in world markets led to our main trading partners' growth estimates being revised down. Given this scenario, the Board thought it prudent to leave interest rates unchanged.

Despite timely monetary-policy action (rate increments, higher marginal reserve requirements, etc.), inflation ended the year at 5.69%, overshooting the upper limit of the 2007 target range by 119 bp, largely because food inflation resulted considerably higher than expected.

CAUSES OF THE FAILURE TO MEET THE 2007 INFLATION TARGET

To explain what caused the 2007 target to be missed, it is important to break down inflation by duration and origin. For instance, when supply shocks occur, such as those resulting from climate change, food prices undergo transitory increases, regardless of the monetary-policy stance. Similarly, price rises for regulated goods and services are set by local or national authorities, over whose administrative decisions independent central banks have no influence. Moreover, when an increase in inflation is perceived to be permanent because it is caused either by strong demand or higher inflation expectations, monetary policy is crucial to stabilizing prices and ensuring long-term economic growth. Most countries, therefore, build core-inflation indicators that exclude from the consumer price index both the groups subject to transitory supply factors and the groups of regulated goods, in order to see the monetary-policy effects on inflation that can be controlled by the central bank. In this connection, a description follows of the main causes of failure to meet the 2007 inflation target. Food inflation contributed most to acceleration in inflation last year, having consistently grown all year long at rates far above the target range, to end up at 8.5%. The rise in food prices is attributable in part to a drop in supply caused by weather conditions (El Niño and La Niña phenomena), strong demand from Venezuela, and some high and sharply rising world commodity prices. Strong demand may also have been responsible for restaurant meals showing an annual price growth of 7.17%, up by 137 bp on a year earlier.

World food-price behavior, one of the causes of missed inflation targets in several countries, was the outcome of various factors. In the first place, high oil prices raised freight charges and the prices of a number of agrichemicals. Another factor was the move toward production of fuels of vegetable origin such as biofuels from cane sugar, corn and corn substitutes, oil plants, etc., which pushed up the international prices of these goods and some farm inputs. Likewise, world demand for energy crop land has gone up, reducing the planting of other food crops, especially for human consumption, and hence their supply. Lastly, mounting food

demand from the larger emerging economies, such as China and India, has also contributed to keeping world food prices elevated.

It is worth noting that in emerging markets a good part of the considerable increase in food consumption is concentrated in proteins of animal origin (beef, pork, chicken, aquaculture products, eggs and milk), which require the same raw materials as are used in producing biofuels (corn, sugar cane, oil plants), and it is the price of these crops that have risen most among farm commodities.

The duration of high world food prices and their impact on expectations of higher prices and headline inflation were underestimated by several central banks, including Colombia's.

Inflation in regulated goods and services (fuel, transport and public services) was far above the target range all year long, ending 2007 at 6.42%. This group was affected by high world prices for oil and oil products. Moreover, greater demand for tourism at home and abroad further contributed to elevating fares for land and air travel.

The traditional measure of core inflation (CPI excluding food) registered annualized price increments of less than 4.5% in ten of the twelve months, ending the year at 4.47%, below the upper limit of the 2007 target range.

Excluding food and regulated goods and services from the CPI gives a core-inflation measure that stood at 3.95% at the end of 2007, having run all year long at annualized rates below the midpoint of the target range. This core-inflation measure can be divided into two groups: i) *tradables*, defined as prices that are strongly affected by the exchange rate, and ii) *nontradables*, the rest of goods and services, which cannot be commercialized internationally and are priced based largely on domestic factors. The two groups behaved as follows:

- Tradable inflation benefited from the peso's appreciation against the dollar (-12%), ending the year at 2.28%, a little higher than in 2006 (1.71%). Strong demand may have been responsible for this behavior not being more consistent with revaluation of the peso.
- Nontradable inflation closed the year at 5.19%, having run all year long at annualized rates between 4.93% and 5.56%. This behavior suggests that domestic demand exerted significant inflationary pressure, a fact borne out by strong growth in domestic consumption, commerce and investment. The nontradables that most contributed to accelerating this inflation between 2006 and 2007 were entertainment-related services, school fees and banking services.

Consumer Price Index
(Annual Change)

Description	2006 (1)	2007 (2)	Acceleration (1) - (2) Basis points	Contribution to acceleration	
				Basis points	Percentage
Total	4.5	5.7	1.2	1.2	100.0
Food	5.7	8.5	2.8	0.9	74.4
Regulated items	6.1	6.4	0.3	0.1	4.1
Nonfood CPI	3.9	4.4	0.5	0.3	25.6
Nonfood nonregulated CPI	3.4	4.0	0.5	0.3	21.5
Tradables	1.7	2.3	0.6	0.1	9.9
Nontradables	4.8	5.2	0.4	0.1	11.6

Source: DANE

POLICY DECISIONS IN JANUARY 2008

In early January, news about the US increased the likelihood of a recession there: corporate and consumer credit became more constrained; labor-market figures deteriorated; oil quotations kept on rising; and share prices fell significantly on several developed-economy stock markets.

In this scenario, uncertainty grew about the size and duration of a possible recession in the US and its effect on other developed countries and also on emerging nations. In the case of Colombia, very low growth in the world's biggest economy could affect our exports, commodity prices, capital flows and remittances, among other things.

In these circumstances, the Board decided to leave interest rates unchanged pending further information about the international scene.

Despite the foregoing, the Bank's technical team estimates that the Colombian economy may have grown by some 7% in 2007 and is likely to expand in 2008 by about the average rate for the past five years. Inflation projections show a high degree of uncertainty, mainly associated with the evolution of domestic and international food prices, changing expectations, and the impact of the world economy on growth in Colombian aggregate demand.

The Board will continue to carefully monitor the international situation, along with inflation behavior and forecasts. They reiterate that future monetary policy will depend on fresh information and the impact of such information on inflation expectations and projected inflation relative to targets.

Board of Directors
Banco de la República