

THE INFLATION TARGETING STRATEGY IN COLOMBIA

OBJECTIVES

Monetary policy in Colombia is based on inflation targeting, which is intended primarily to keep inflation low and to ensure stable long-term growth in output. Accordingly, the objectives of monetary policy combine the goal of price stability with maximum sustainable growth in output and employment. In this respect, monetary policy complies with the constitution and contributes to the well being of the Colombian population.

HORIZON AND IMPLEMENTATION

The Board of Directors of the Central Bank of Colombia (BDBR) sets quantitative inflation targets for the current year and the next. BDBR policy initiatives are designed to meet each year's target and to provide for long-term inflation at around 3%. The annual variation in the consumer price index (CPI) is the inflation measurement used.

THE DECISION-MAKING PROCESS

Monetary-policy decisions are based on an analysis of the current state of the economy and its prospects for the future, and on an assessment of the forecast for inflation in light of the targets. If the assessment suggests, with enough certainty, that inflation will deviate from its target under current monetary-policy conditions and the deviation would not be due to temporary shocks, the BDBR modifies its policy stance. For the most part, this is accomplished by changing the intervention interest rate (charged by the Central Bank of Colombia on short-term liquidity operations).

COMMUNICATION AND TRANSPARENCY

decisions on monetary policy are announced after meetings of the Board of Directors, through a press bulletin posted immediately on the Bank's website (www.banrep.gov.co). Inflation reports are published quarterly and lend transparency to the Board's decisions. They also contribute to a better understanding of monetary policy and help to enhance its credibility. Specifically, these reports i) let the public know how the Board of Directors and the Technical Governor of the Bank view recent and anticipated changes in inflation and its short and mid-term determinants; ii) explain the implications of those determinants for monetary-policy management within the scope of inflation targeting; iii) describe the context and analysis justifying monetary-policy decisions made during the quarter; and iv) provide information that helps economic agents to form their own expectations about future developments with respect to inflation and growth in output.

ASSESSMENT OF INFLATION AND POLICY DECISIONS

Inflation during the past quarter continued the downward trend registered throughout 2009, ending the year at 2%. This is below the target range established for that year (4.5% to 5.5%) and at the floor of the long-term target range for inflation (2% -4%). During the same quarter, a historically high proportion of sectors in the food and non-food categories of the consumer price index (CPI) registered negative monthly inflation.

Last quarter, 62% of the slowdown in annual inflation (-120 basis points [bp]) was due to less of an adjustment in the food CPI, which is the spending group that ended with a negative annual variation (-0.3%). The decline in the annual variation in this group was generalized, with nonperishable foods, beef and beef substitutes contributing the most to this trend. The cost of perishable foods declined as well, but at a slower pace compared to earlier this year.

The non-food CPI (2.9%) also slowed significantly during the past quarter, as did the other core inflation indicators traditionally calculated by Banco de la República. In fact, all the core inflation indicators were within the long-term target range for inflation. Expectations of inflation at different appointed dates, as reflected in surveys or those resulting from government debt paper (TES) showed a similar pattern. At one year, inflation expectations are under 4%. At five and 10 years out, they were within the long-term target range in December, but increased in January to between 4.0% and 4.5%.

Figures on economic activity reflected an absence of demand-pulled inflationary pressures. GDP levels increased during each of the first three quarters of the year; however, the third-quarter increase was less than anticipated in earlier editions of this report. Consumption showed positive annual growth, fueled entirely by government spending. Household consumption did not increase in

annual terms. Investment was meager and declined compared to the level on record for the same period in 2008. The drop in investment would have been greater had it not been for the sharp increase in civil works. The slowdown in exports and imports continued.

Available indicators of supply and demand in the final quarter of 2009 show a continuation in the tendency for the economy to recover slowly. Most of those indicators reflect added quarterly and annual growth; the latter was due, in a number of cases, to the limited amount of activity witnessed a year earlier. Accordingly, the fourth quarter of 2009 is likely to see positive annual economic growth and an annual variation of around 0% in GDP for the year as a whole.

The slow recovery in aggregate demand was accompanied by limited use of the country's productive capacity. Together, these factors contributed to the reduction in inflation during 2009. During the past quarter, the indicators of industrial installed capacity utilization published by Fedesarrollo and ANDI showed levels similar to those on record at the start of the decade, and are well below the highs observed between 2006 and 2007. Factors such as less internal and external demand and the restrictions on trade with Venezuela contributed to this outcome. In this sense, although industrial production is expected to recover in 2010, surplus installed capacity among companies can lead to price stability or low price hikes.

Consumer and business opinion polls continued to reflect substantially higher expectations for economic activity at different time horizons, suggesting the increase may continue into 2010. Similarly, the models used by Banco de la República's technical team forecast between 2% and 4% economic growth in 2010; however, it most likely will be at the bottom of the range.

As for the job market, the supply of labor continued to expand more than the demand for labor, as reflected by the steady rise in the unemployment rate. Employment continued to increase during the moving quarter ended in November 2009 and even accelerated, but there were still more people looking for work. In the end, the result was an increase in the unemployment rate for the thirteen major cities to levels similar to those reported in mid-2006 and more than two percentage points above the low point for the decade, which was in 2007. The job market in 2010 probably will remain loose and wage pressure is likely to be subdued.

The gross portfolio, plus leasing, showed signs of stabilizing towards the end of 2009 and in early 2010, following a steady slowdown in annual growth since they start of 2007. In December and the first two weeks of January, the mortgage portfolio continued to post important gains and consumer lending showed signs of recovery; that is, when the seasonal component is deducted from the portfolio figures. Commercial lending was the type of credit that slowed the most in 2009, partly because of the large bond issues floated

by major companies. All types of lending, with the exception of mortgage loans, grew at positive rates that can be classified as low. This is according to the figures at December and in real terms. At any rate, the total gross loan portfolio (plus corporate bonds) as a portion of GDP is at its highest level for the decade. Moreover, the risk indicators for the total loan portfolio stabilized; specifically, the quality of consumer and mortgage loans improved, while commercial lending deteriorated slightly.

Banco de la República's policy interest rate is still being passed through to market interest rates. The figures for the first fifteen days in January showed interest rates on deposits and on household and commercial lending declined again, although less so than in December 2008. Accordingly, the benchmark rate as it now stands should continue to encourage economic growth in an environment characterized by a healthy financial system.

As for the external environment, global economic activity continued to recover during the fourth quarter of 2009, particularly due to the monetary and fiscal stimuli provided by developed countries and the impulse observed in Asian countries such as China and India. This recovery is reflected in enhanced world trade and in better international commodity prices, which are above their historic average. Consequently, the external context for Colombia in 2010, excluding the Venezuelan market, is more favorable than it was in 2009, thanks to: I) a revival of external demand; II) international prices for our commodities that are above the historic average; and III) an international interest rate at levels that reduce the cost of financing international trade.

Colombian exports to Venezuela feasibly could plunge to historic lows during 2010 if the restrictions on sales to Venezuela continue. The impact of such a shock on the country's economic activity would depend not only on whether or not Colombia's export sector can find new markets, but also on international competition for Colombia products and the recovery in external demand worldwide. At the same time, an increased local supply of these goods will help to keep prices stable or to keep price hikes low.

The models calculated by the Bank's technical team, which are updated with key supply and demand determinants of inflation, suggest that the annual change in the CPI could increase during the first half of 2010, but would slow again towards the end of the year, ending within the long-term target range. This is due to the effect the current bout of El Niño weather might have on prices. As the records show, when this phenomenon is not accompanied by demand-pulled pressures or sudden increases in international prices or in the price of the dollar, the impact on prices is temporary and generally tends to reverse during the final quarter of the year.

The macroeconomic scenario described above was the basis for the decisions taken by the Board of Directors of Banco de la República (BDBR) between November 2009 and January 2010.

On November 23, the BDBR decided, by a majority vote, to lower its intervention interest rate by 50 bp to 3.50%. This decision was motivated by several factors; namely, I) annual inflation that declined faster than expected and, given current expectations, should be within the long-term target range for inflation; II) slower than estimated economic growth, coupled with a portfolio that continued to slow; and III) the drop in trade with Venezuela and the anticipated decline in that country's GDP during 2009 and 2010. Consequently, the 50 bp cut in the intervention rate was intended to bolster economic recovery and to reduce the negative effects of the collapse in trade with Venezuela.

In December 2008 and in January of this year, the BDBR analyzed the international situation once again, as well as the forecasts and performance with respect to inflation and growth. After doing so, it decided to hold the benchmark interest rate steady. The BDBR will continue to monitor these variables carefully and reiterated that future monetary policy will depend on whatever new information becomes available.

Board of Directors
Banco de la República