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 the stability of long-term growth in output. Monetary policy objectives, therefore, combine the goal of price stability with maximum sustainable growth in output and employment. In this way, monetary policy complies with the constitution and contributes to the well being of the Colombian population.

Horizon and Implementation

The Board of Directors of Banco de la República (BDBR) defines quantitative inflation targets for the year in progress and the next. BDBR policy initiatives are designed to meet each year's target and to place 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 compared to the targets. If the assessment suggests with enough certainty that, under current monetary-policy conditions, inflation will deviate from its target during the course of that policy, and the deviation would not be caused by temporary shocks, the BDBR modifies the stance of its policy. This is done primarily through changes in the intervention interest rate (charged by Banco de la República on short-term liquidity operations).

Communication and Transparency

Monetary policy decisions are made at meetings of the Board of Directors and announced immediately thereafter through a press bulletin posted on the Bank's website (www.banrep.gov.co). The inflation reports are published quarterly and lend transparency to the Board's decisions. They also contribute to a better understanding of monetary policy and add to its credibility. Specifically, they 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 medium-term determinants; ii) explain what those determinants imply for monetary-policy management within the scope of inflation targeting; iii) describe the context and analysis justifying monetary-policy decisions during the quarter; and iv) provide information that helps economic agents to form their own expectations about prospects for inflation and growth in output.

Assessment of Inflation and Policy Decisions

Inflation Summary

- In December, annual consumer inflation was 4.48% (as opposed to 4.58% in September). This is at the center of the target range for 2006. Although the growth in inflation at December was consistent with expectations, the rise in non-food consumer prices (CPI) and other core inflation indicators, which averaged 4.52%, was a surprise.

- The increase in non-food inflation is explained primarily by non-tradable goods and services, excluding food and regulated items. Tradable inflation remained stable, consistent with the trend in the exchange rate.

- Consumer inflation for the year as a whole declined from 4.86% in 2005 to 4.48% in 2006, primarily due to less of an increase in prices for perishable foods and tradable goods. In the case of tradables, the reduction was attributed to an adjustment in long-distance telephone rates. Non-tradable inflation, excluding food and regulated items, went from 4.57% to 4.75%.

- Third-quarter GDP growth (7.7%) surpassed expectations. Most of the increase was in private GDP, which was up by 8.7%. The rise in domestic demand (9.7%) was due largely to further growth in household consumption and investments, especially in machinery and equipment (19.3% during the quarter) and in construction and buildings (24.5%). Total exports continued to perform well and accelerated in real terms.

- The forecasts for growth during 2007 are revised upward in this report. Domestic demand should continue to rise at a vigorous pace, given the momentum in private consumption and investment. Compared to 2006, more of an increase in public consumption is expected. Accordingly, economic growth during 2007 should be somewhere between 4.4% and 6.6%.

- External conditions are expected to continue to favor good economic performance in Colombia throughout 2007. A slight decline in demand on the part of our trading partners is anticipated (with respect to 2006), but terms of trade should remain high, although not at the level seen in recent years. Risk perception on the financial markets would stay relatively low, thanks to ample liquidity in the international context. Given this scenario, the United States Federal Reserve Bank (Fed) is not expected to raise interest rates.

- The quick expansion in credit continues. The peso loan portfolio in the financial system is up by 34.9% and consumer loans, by 48.3%. Some of this performance is due to the increase in credit supply created when credit institutions shifted a portion of their portfolios from investments in TES to loans. In fact, between March and December 2006, they reduced their TES holdings by nearly $4.2 trillion pesos.

- Part of the Bank's interest rate hikes (150 basis points (bp) between April and December) were passed through to the market rates. Interest rates on time certificates of deposit at different maturities rose by 87 bp, on average, during that period. Real lending rates on preferred and treasury loans increased, but the others are down (ordinary, consumer and credit card loans).

Policy Decisions

- The following are the major changes with respect to the inflation analysis in the September report:

    - Evidence of acceleration in aggregate demand emerged, raising the growth forecasts for 2006 and 2007.

    - The late third-quarter reduction in non-tradable inflation without food and regulated items was reversed at the end of 2006. As a result, non-tradable inflation without food and regulated items finished the year at 4.75%, which is more than in 2005 (4.57%). The average for core inflation went from 4.25% in September to 4.51% in December, continuing its upward trend.

    - The peso continued to appreciate, raising the exchange rate from $2,400 per dollar in September to $2,238 at the end of December.

    - Inflation was 4.48% in 2006, which is slightly below the forecast published in the September edition of this report (4.6%). In other words, the inflation target was met at the center of the 2006 range (between 4% and 5%).

- These elements, on the whole, imply an increased risk of inflationary pressure compared to the pressure discussed in the September report. This is due to the following reasons:

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    - The next few quarters are expected to see no significant slowdown in the growth of aggregate demand. External conditions remain favorable, real domestic interest rates are historically low, and credit continues to grow at a fast pace, particularly consumer loans.

- The calculation on *rate of installed capacity use* is highly uncertain. However, different methods suggest it continues to increase compared to the estimates published in the September inflation report. This means the margin that existed previously with respect to the *rate of use consistent with price stability* continues to decline.

- Although compliance with the inflation target for the third year in a row increases the credibility of the 2007 target, total inflation anticipated during the first half of the year could have a negative impact on inflationary expectations. In fact, the forecasts indicate it will be above 4.5% during that period (the top of the target range for the year). This would be due to food prices (affected by El Niño weather) and prices for regulated items (because of the low levels compared to 2006). These effects are temporary and would tend to be reversed during the second half of the year. However, if transmitted to inflationary expectations, they could have a more permanent impact.

- Although movement in the exchange rate is a highly uncertain variable, tradable inflation is not expected to make a further contribution to reducing total inflation.

- Given this context, the BDBR decided to continue to reduce the Bank's monetary incentive by adding 25 bp to the intervention interest rate on three occasions: in October, December and January. The last of these increases placed the base rate for expansion auctions at 7.75%.

- The decision to continue the monetary standardization process ratifies the Board's commitment to adopting the measures required to ensure that inflation converges towards its long-term target. The gradual elimination of monetary incentives does not affect the Colombian economy's capacity for growth in terms of its potential. On the contrary, it lends continuity and sustainability to the economy.

- There are risks associated with the external context that can raise the exchange rate and the country-risk premium. These could originate with expectations of additional rate hikes by the Fed, more of a downturn in commodity prices, or a reduction in capital flows to the emerging economies, which could heighten the risk of inflation, given the impact of peso depreciation on tradable inflation and possibly on expectations of inflation. Some of these events could have a negative impact on economic growth in Colombia (as would be the case with a drop in terms of trade), thus reducing potential demand-pull inflationary pressures. The country's monetary authority must consider these risks and identify their possible effect on inflation forecasts.

- The early months of 2007 are expected to see a strong influx of foreign exchange from the sale of public-sector assets. This monetization could unnecessarily and temporarily aggravate interest rate volatility and the prices of other assets. Therefore, the Board of Directors felt it was appropriate to announce its intention to intervene in the exchange market on a mass scale. In any case, this will be done in a way that does not move the Bank's interest rate away from a level that is compatible with achieving the inflation targets for 2007 and 2008.

Board of Directors, Banco de la República