



Monetary Policy Challenges under Tighter External Financial Conditions

“The Shadow of Neo-Protectionism and Coping with the Challenges of the Normalization Process” (Reinventing Bretton Woods Committee/Bank of Indonesia/UBS)

Gerardo Hernández
Board Member

These views are personal and do not represent those of the Central Bank or its Board of Directors

Policy challenges

- **External Risks and Policy Challenges**
 - First line of defense: Exchange rate flexibility but there are preconditions
 - Limited currency mismatches
 - A credible monetary regime
 - Sound and robust financial sector
 - Sound fiscal policy
 - Second line of defense: External buffers
- **Other Policy Challenges**
 - Higher participation of foreign investors in local public debt market poses other policy challenges.
 - Higher debt

Current policy challenges are linked to changes in external conditions

- Financial
 - Monetary policy normalization in advanced economies
 - Increases in risk aversion
 - USD appreciation
- Non-financial
 - Decrease in commodity prices
 - Changes in international trade policies

Policy challenges

- **External Risks and Policy Challenges**

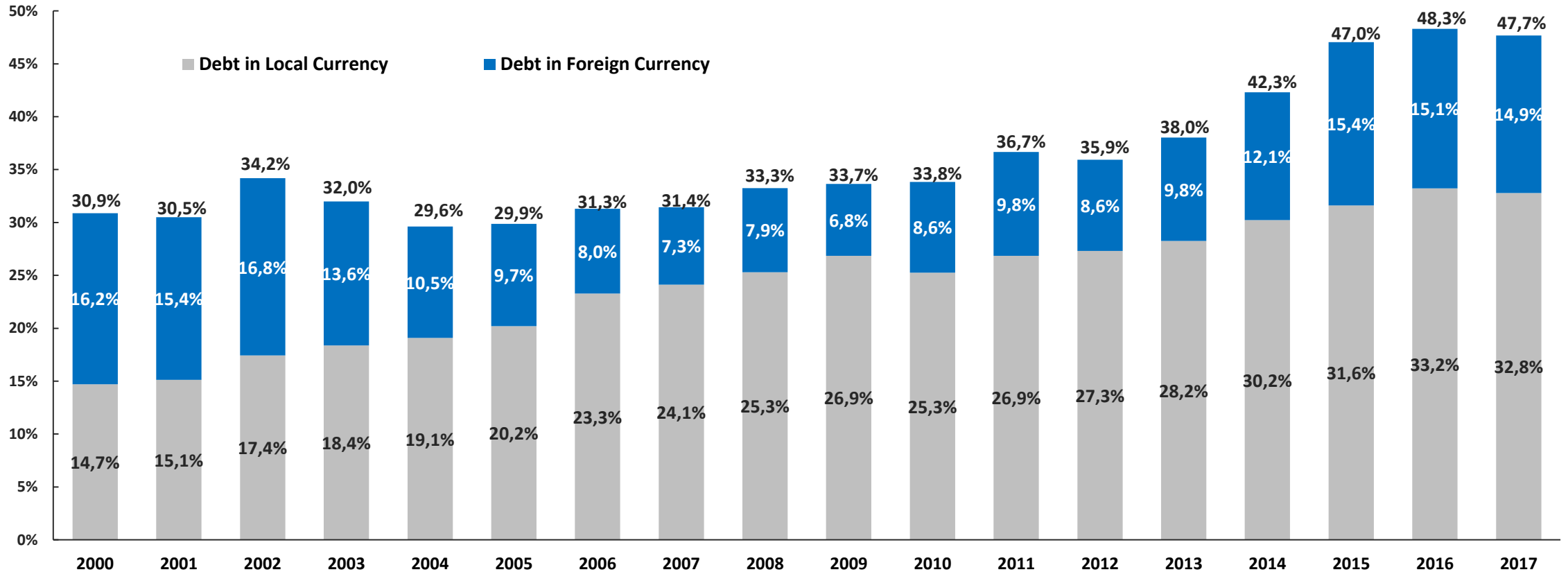
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Currently, debt denominated in foreign currency is not a source of concern. However, we continue monitoring the evolution of private sector indebtedness.

Debt of the Non-Financial Corporate Sector by Currency (% of GDP)

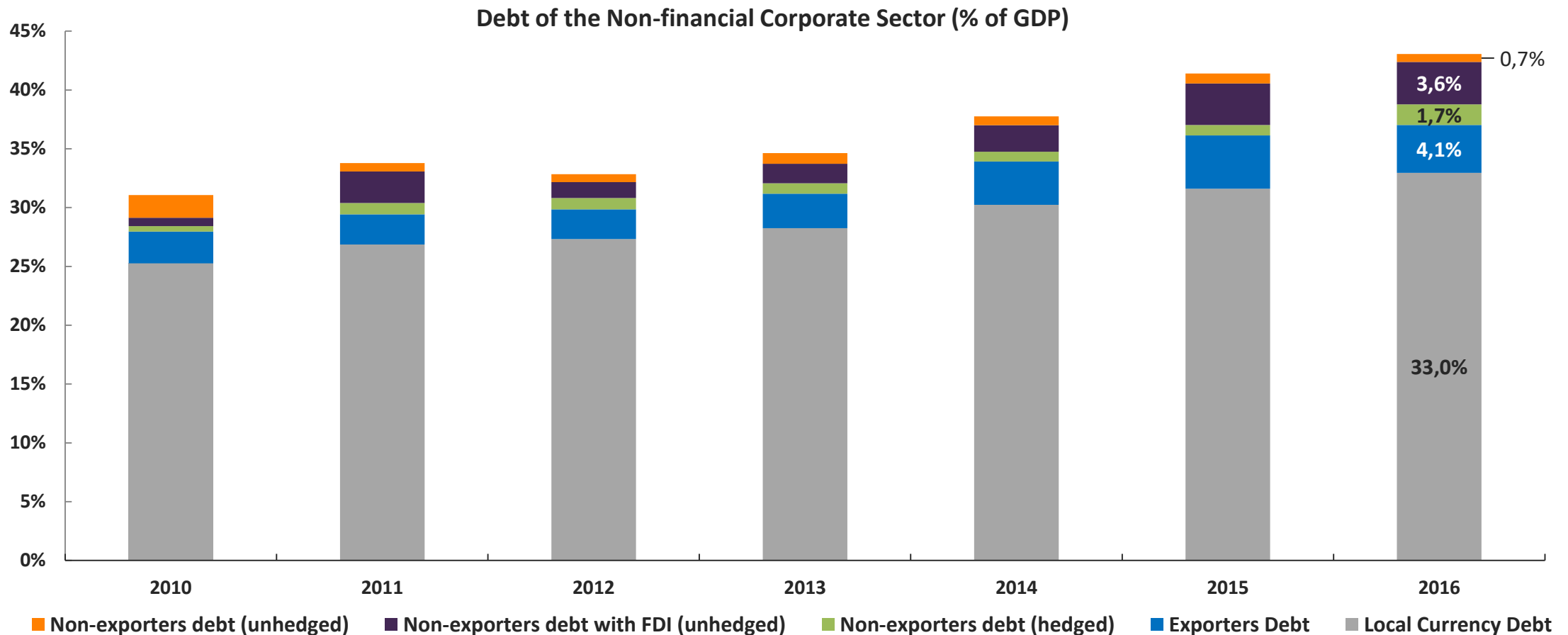


Source: Banco de la República

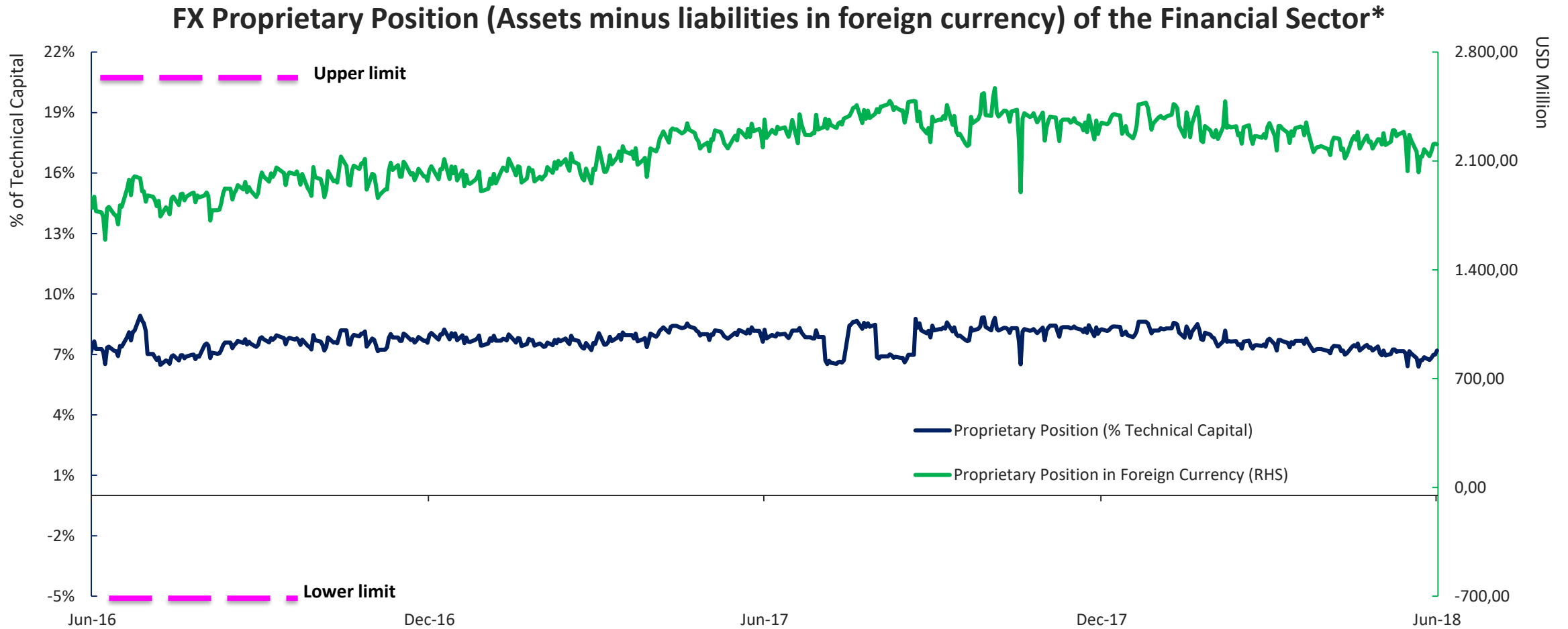
- Financial exposure of households to exchange rate fluctuations is almost null.

Unhedged corporate external debt represents a small fraction of private sector liabilities

- A large proportion of the debt in foreign currency is either hedged or in hands of exporters, thus reducing the FX risks.



The exposure of financial intermediaries to exchange rate risk has kept low and relatively constant during last years.

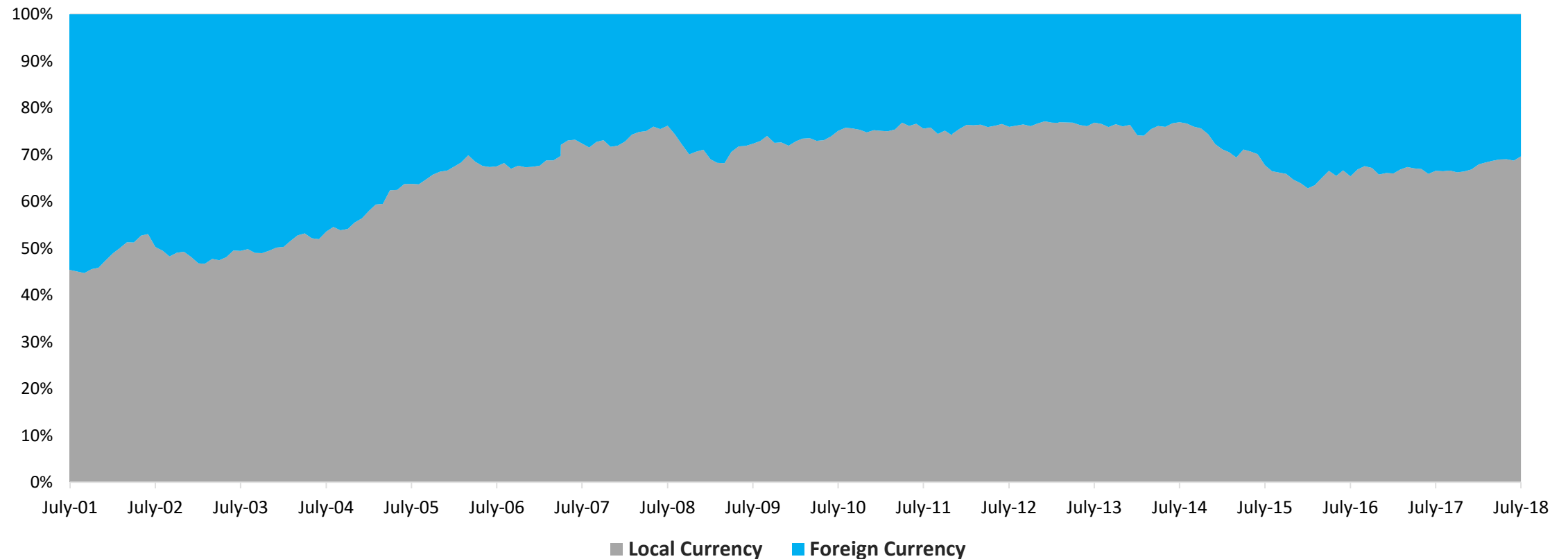


*FX Market Intermediaries: Includes credit establishments and brokerage firms.

Source: Banco de la República

The foreign currency debt remains in low levels as a percentage of the total public debt.

**Public Debt Balance
(local vs. foreign currency)**



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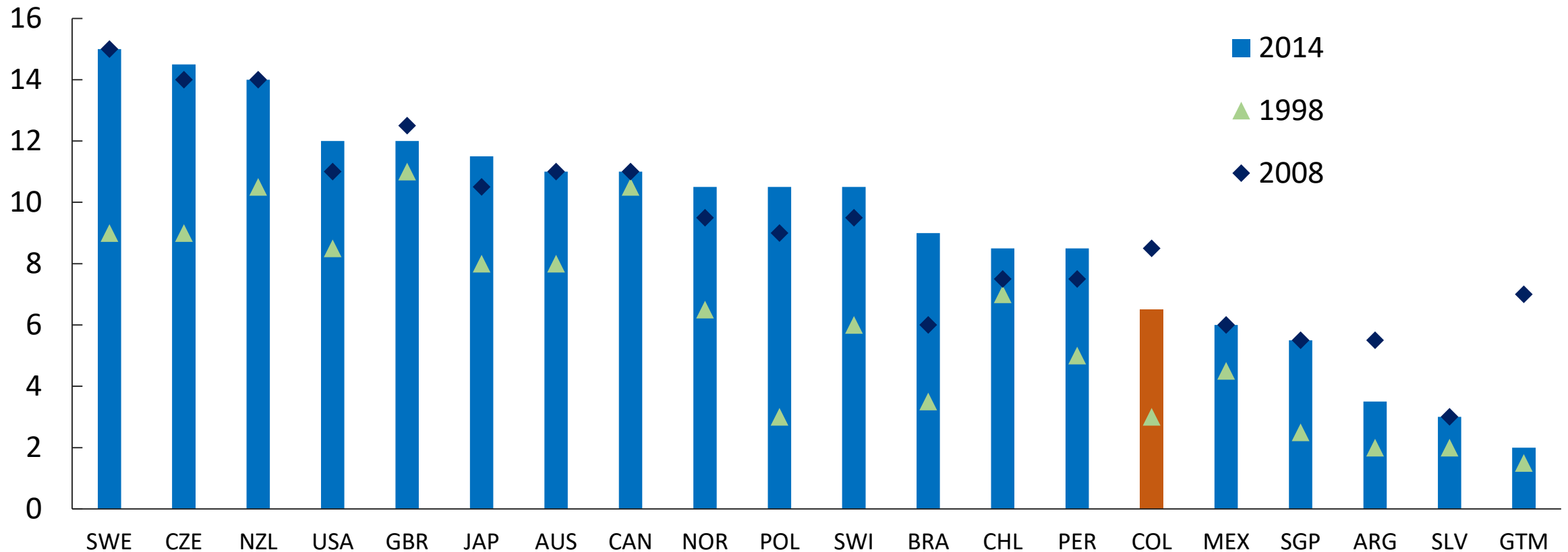
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A credible monetary regime is supported by high levels of transparency and an effective communication.

Despite some enhancements, there is still a significant room for improvement.

Central Bank Transparency Index*

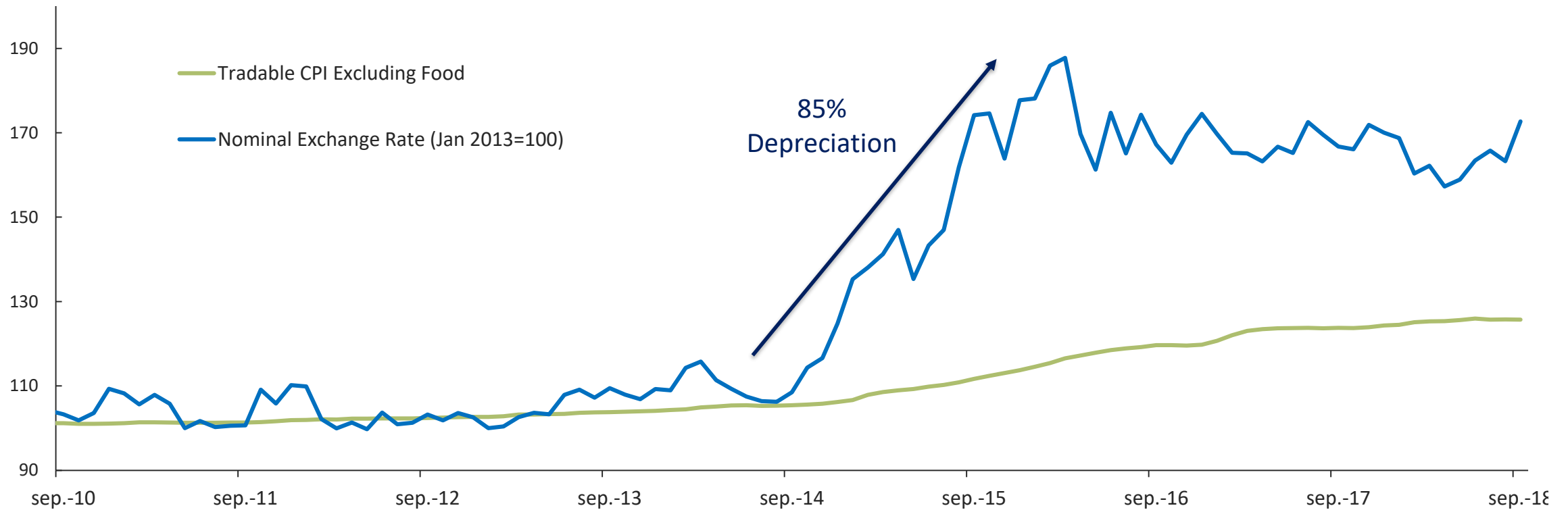


*The maximum value of the index is 15. The index is built using five categories: Political, economical, procedural, policy, operational. Each category has a value between zero and three.

Source : Dincer and Eichengreen (2014).

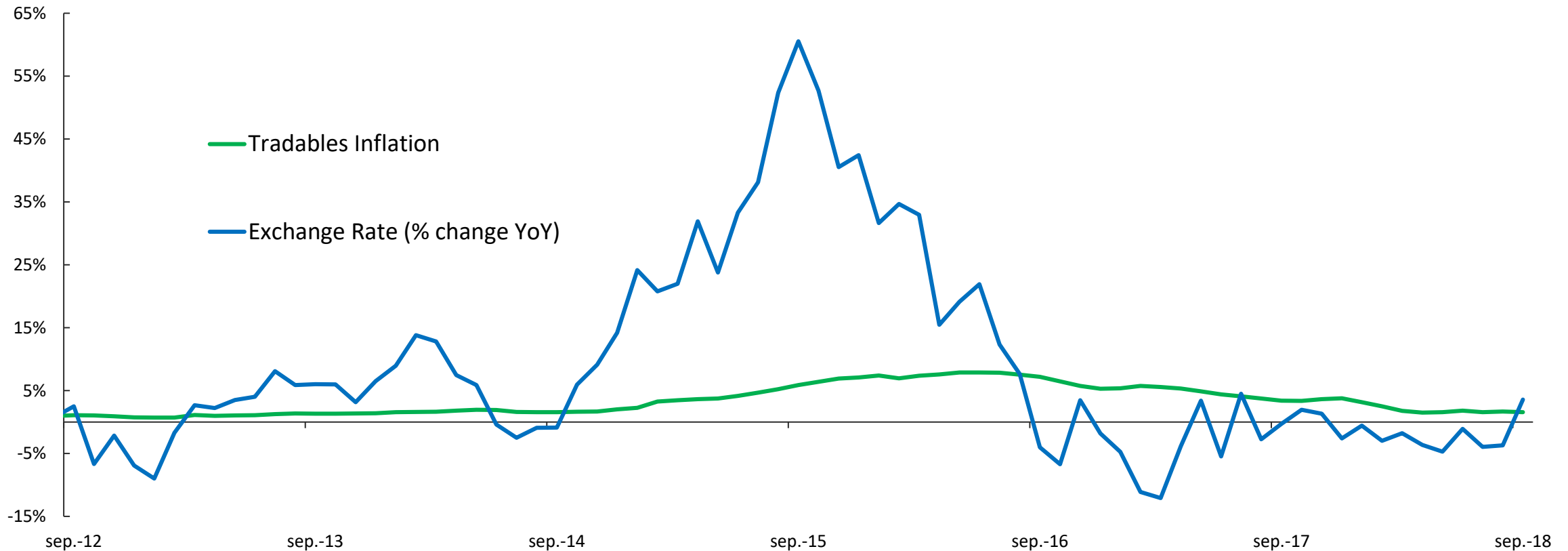
A credible monetary regime supports a low level of pass through from exchange rate to prices

- Exchange rate works as an effective shock absorber if episodes of currency depreciations do not threaten credibility on price stability objectives.
- The 2014-2015 episode showed a relatively small increase in the tradable CPI, despite the large currency depreciation



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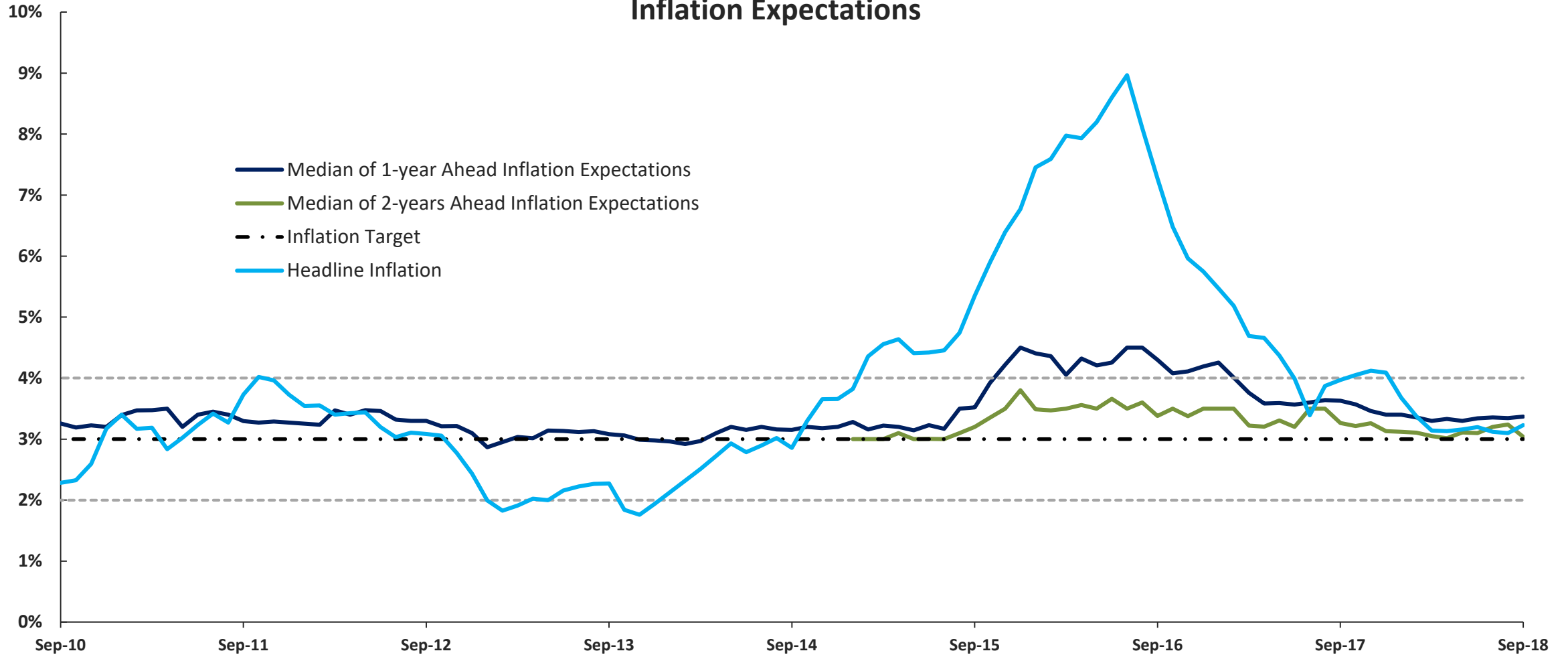
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- The 2014-2015 episode showed a relatively small increase in the tradable CPI, despite the large currency depreciation.



Source: DANE and Banco de la República

The low pass through could be partially accredited to the credibility of the inflation targeting regime. Therefore, improving communication and transparency is still one big challenge.

Inflation Expectations



Source: Banco de la República – Monthly Survey of Economic Expectations

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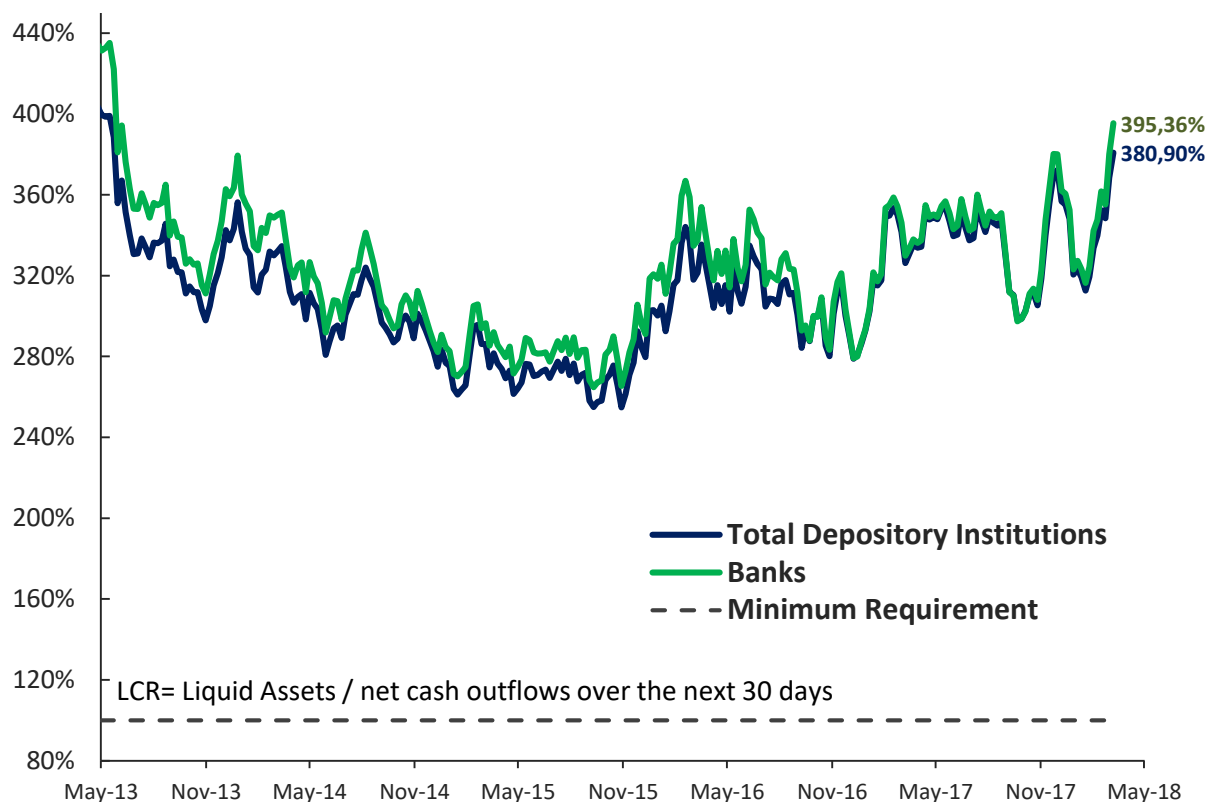
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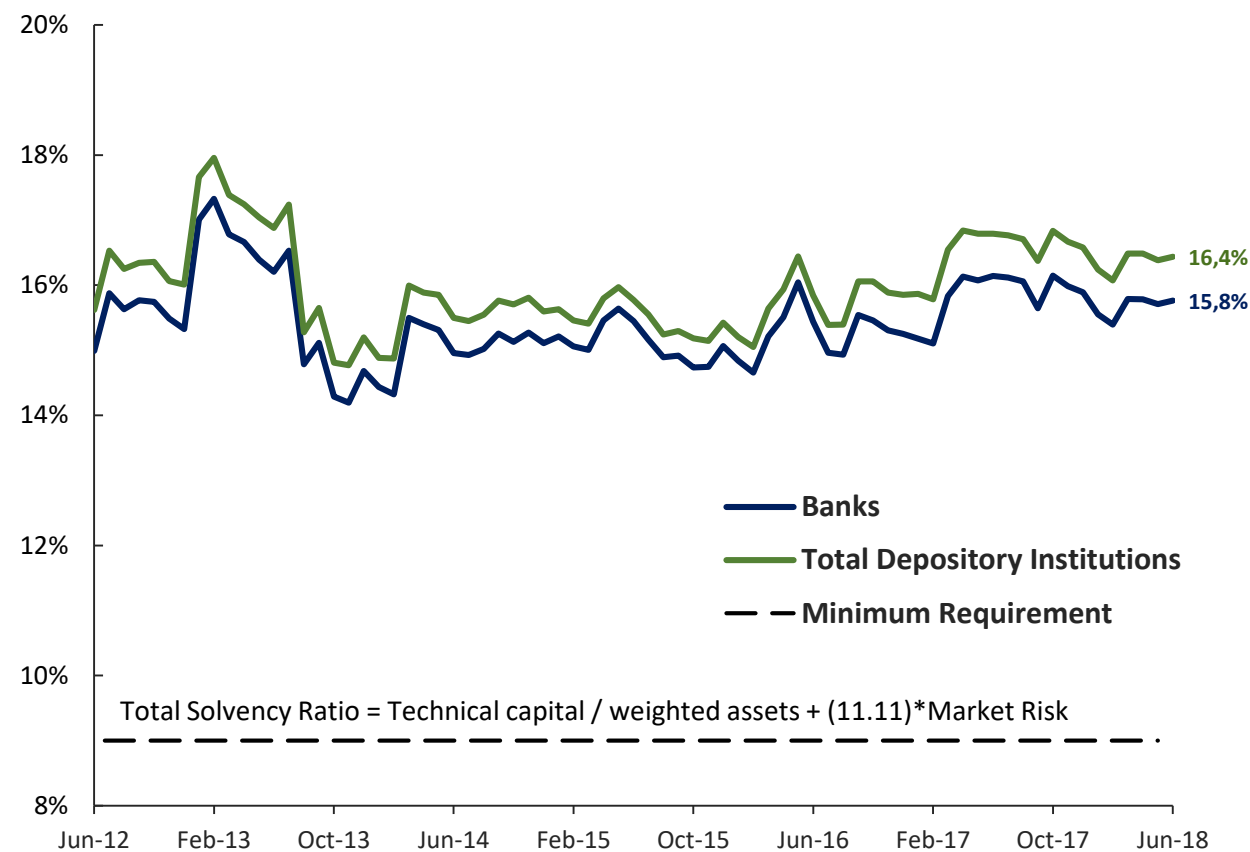
Local banks are resilient to tighter external conditions

- Throughout the last few years, the Colombian banking system has kept solid liquidity and solvency indicators.
- This has occurred despite the adjustment of the Colombian economy to negative external shocks. At the same time, domestic regulation has contributed to building buffers for credit risk (e.g. dynamic provisioning) and liquidity risk.

30-Day Liquidity Coverate Ratio¹ (LCR)



Total Solvency Ratio (Tier II)



¹ 30-Day LCR is the ratio of high quality liquid assets to total net cash outflows over the next 30 calendar days.

Source: Superintendencia Financiera de Colombia. Calculations by Banco de la República.

Local banks are resilient to tighter external conditions II

- The latest **stress test exercise** simulates the effect of a full exit of foreign investors from domestic public/private debt markets together with a significant fall in GDP growth (1.3% for 2018).
- Under this extreme scenario the estimated cumulative losses would generate a reduction in Tier 1 Capital Ratio from 11,6% to 9,8% well above the regulatory minimum: 4,5%.

Policy challenges

- **External Risks and Policy Challenges**

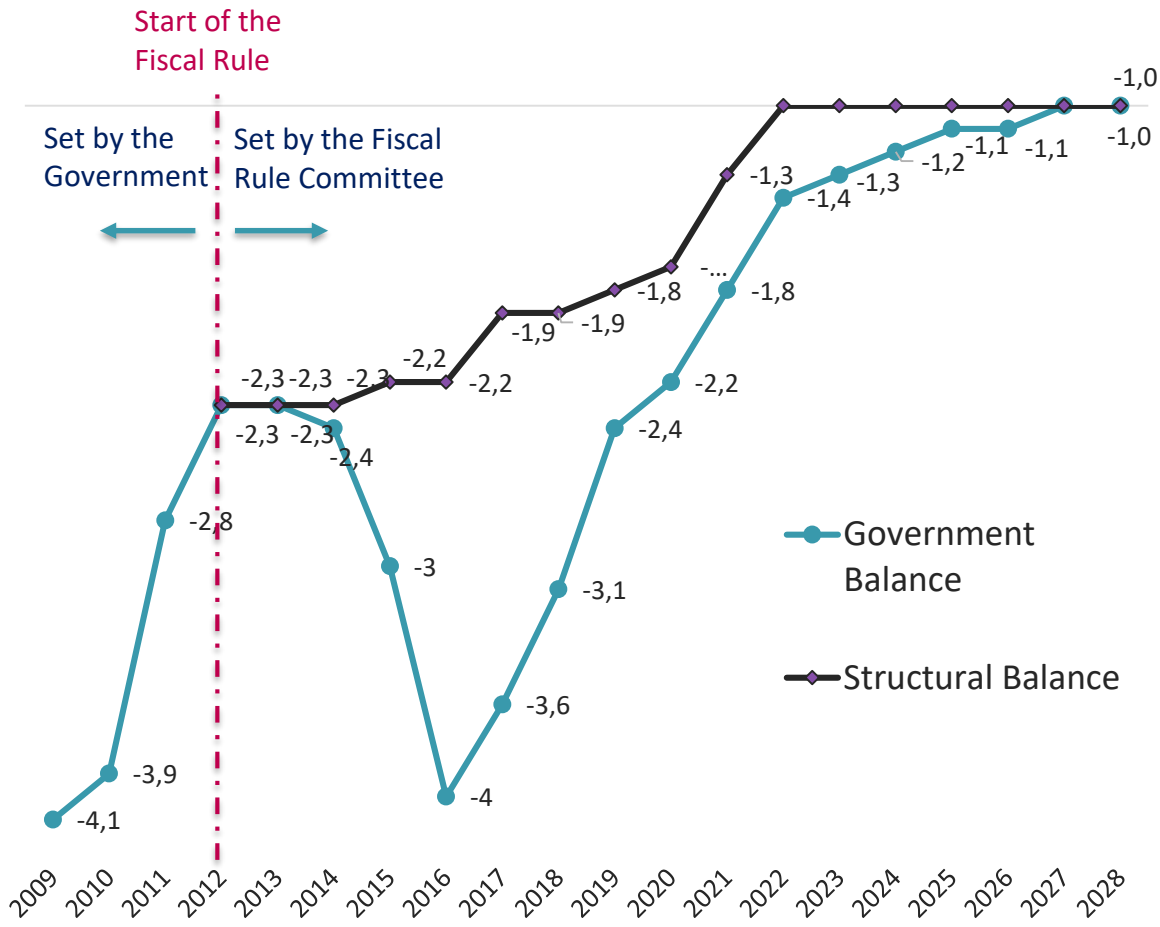
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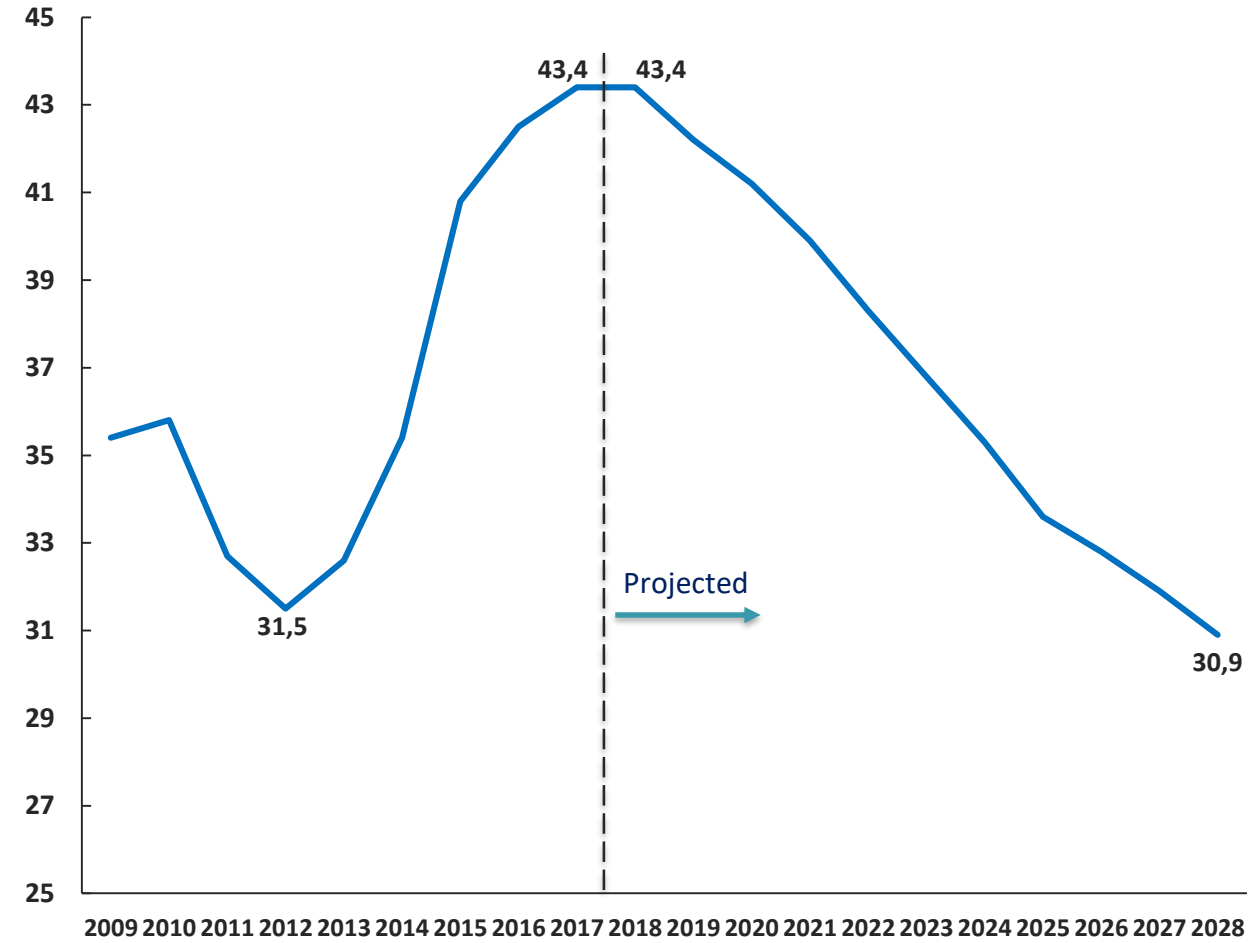
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Maintaining a sound and credible fiscal policy lowers the vulnerability to external shocks

Deficit Allowed by the Fiscal Rule (%GDP)

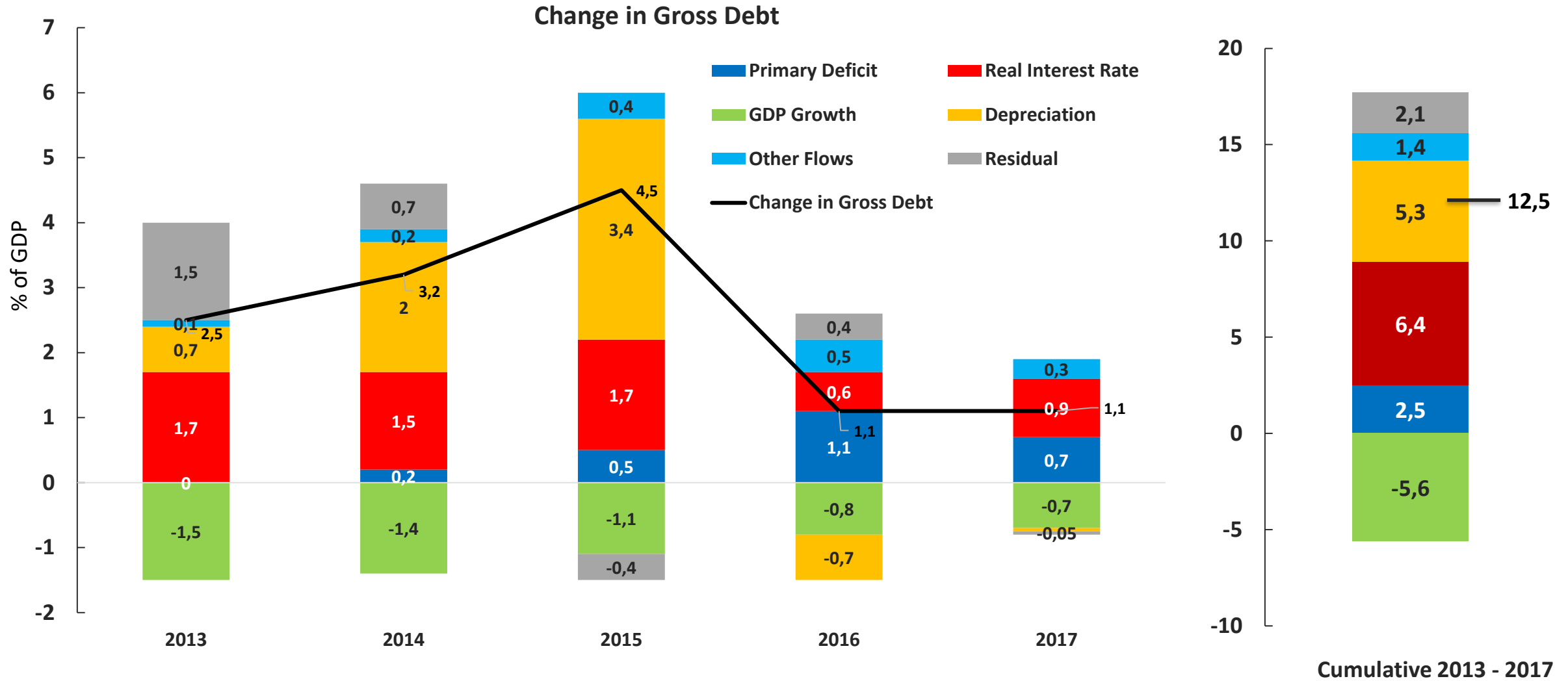


Public Debt (% of GDP)



Source: Ministry of Finance

- During the last years the interest rate and the devaluation of the exchange rate are the main factors that explain the growth of public debt.



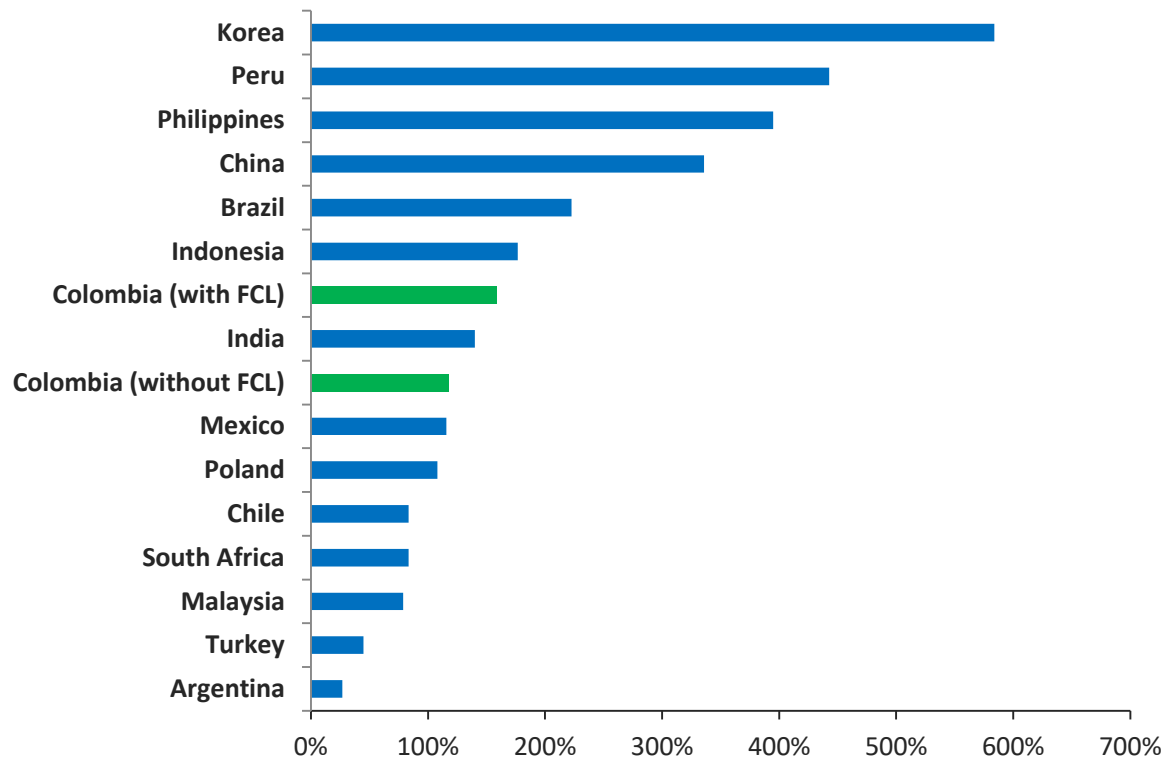
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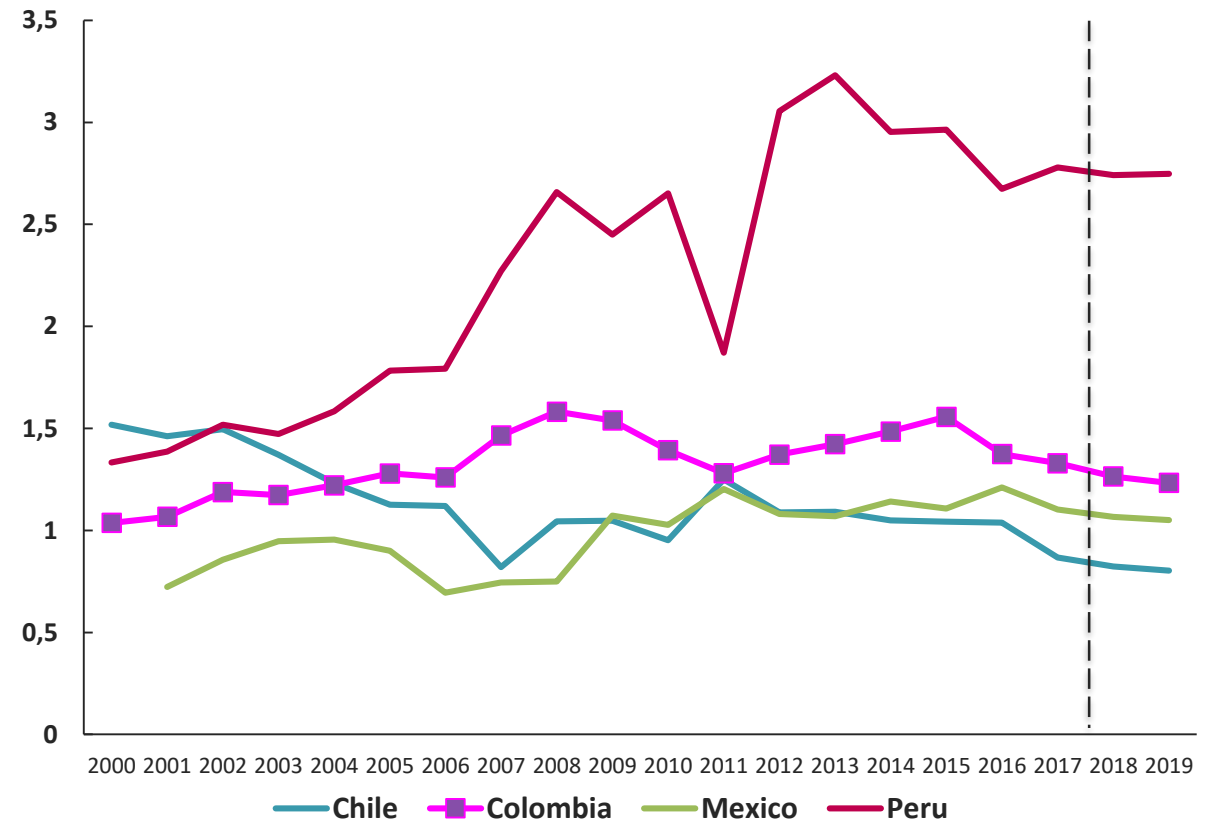
A sufficient level of external buffers provides another safeguard against external shocks.

The Flexible Credit Line (FCL) by the IMF has complemented the accumulation of international reserves.

International Reserves to Short-term Debt and Current Account Balance



Ratio of Reserves/ARA Metric*



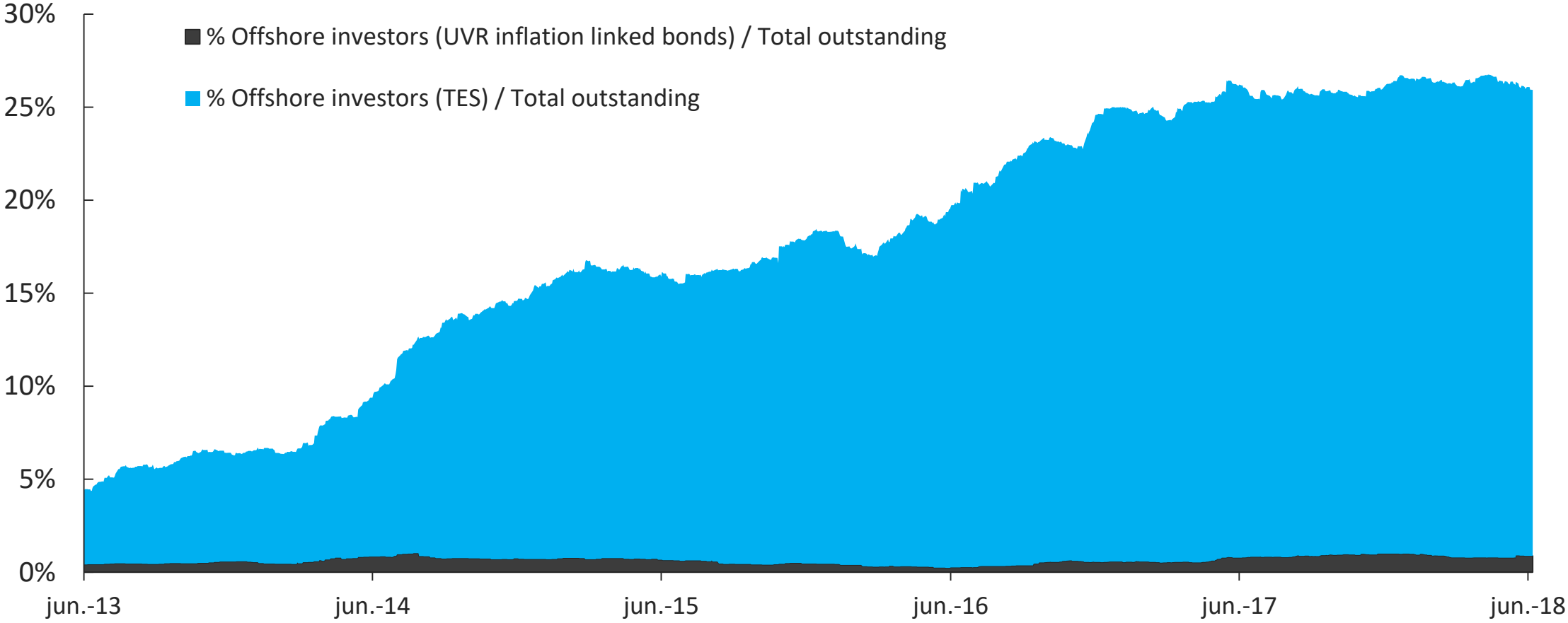
*A ratio between 1 and 1.5 is considered adequate

Source: IMF.

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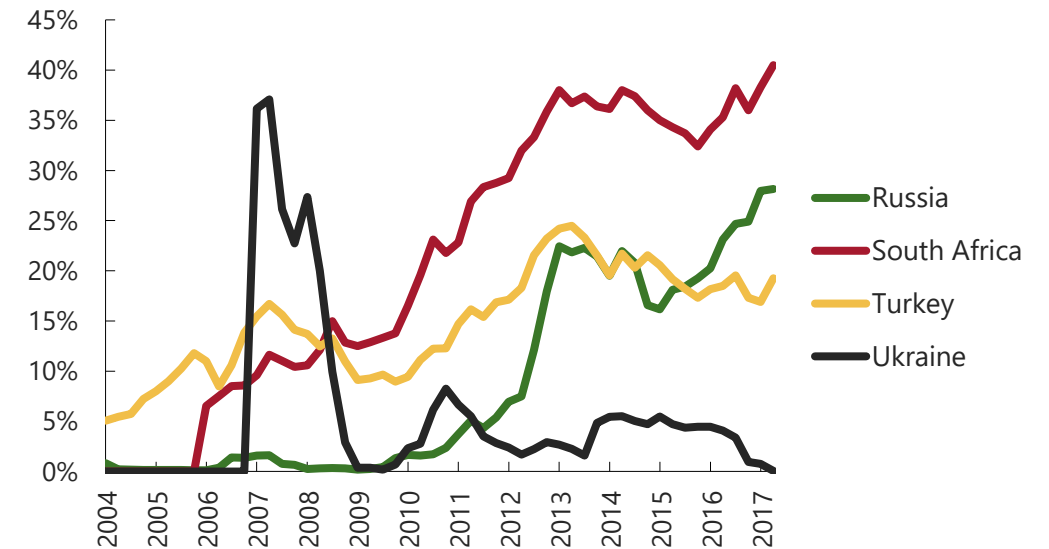
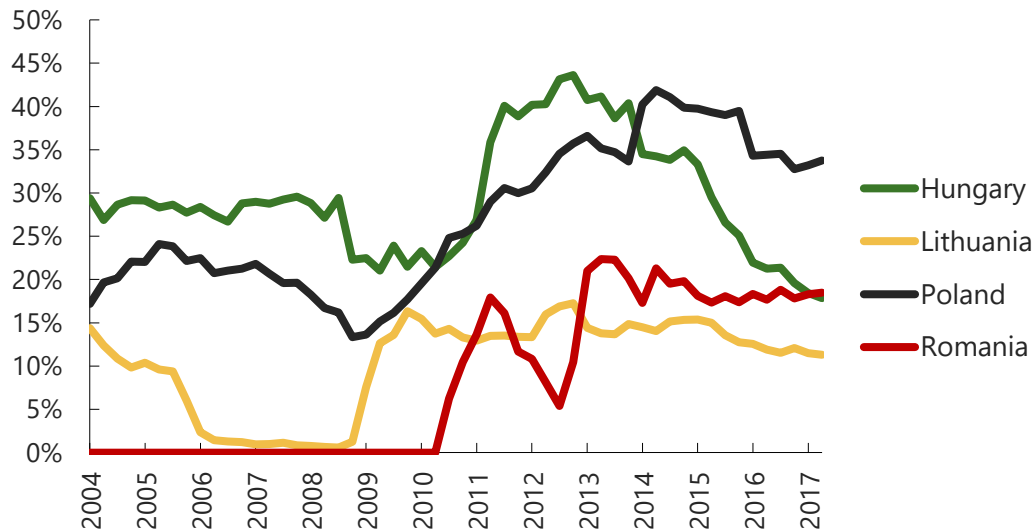
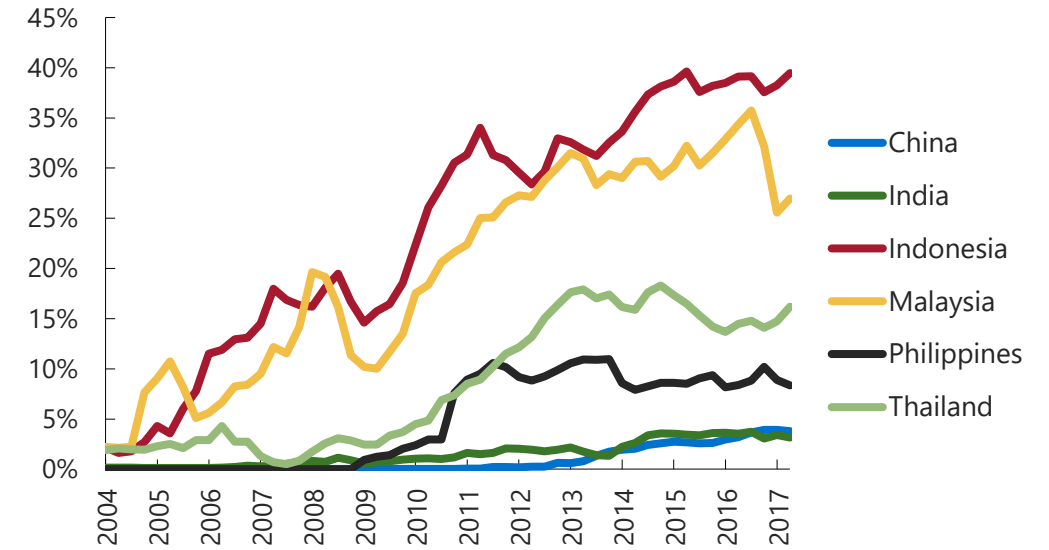
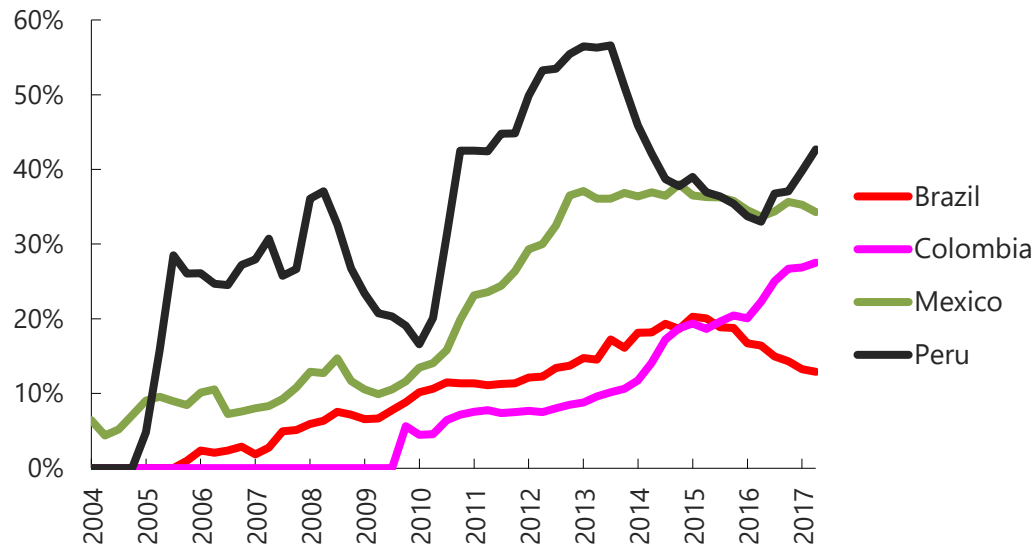
The development of the public debt market came hand in hand with an increased participation of foreign investors, particularly in recent years. This increase was mainly driven by the reduction of withholding tax for offshore investors (from 33% to 14%) and the increase of Colombian debt weight in the JP Morgan's GBI index since 2014.



Source: Banco de la República

The higher presence of offshore investors in Colombia goes in line with the experience of other emerging markets.

Foreign Holdings of Local-Currency EM Government Debt Securities (% of total)



Source: IMF WP - Arslanalp and Tsuda (2017)

A Higher Participation of Non-Resident Investors in the Local Public Debt Market is Welcomed but Creates Challenges

- The increase in offshore participation has been positive for diversifying the Government's financing sources and has helped to finance the current account deficit **facilitating the adjustment of the economy to external shocks**. In addition, **the currency risk is assumed partially by foreign investors**.

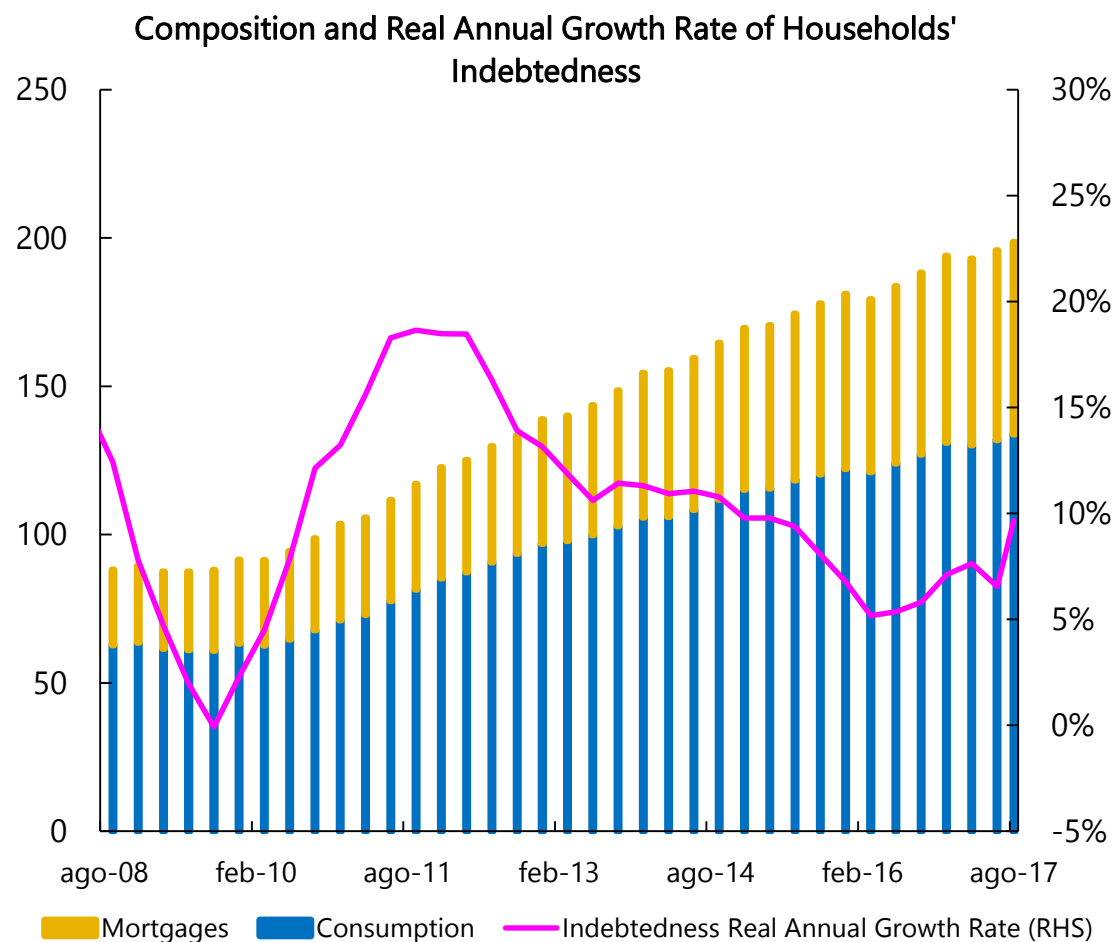
BUT...

- Foreign investors' decisions could affect interest rates along the curve **offsetting in some cases the transmission of monetary policy to bonds with longer maturities**.
- A sudden exit of foreign investors could create **pressures on the exchange rate**. **A big reaction of these agents could amplify the effects of external shocks with possible implications on financial markets and financial stability**.

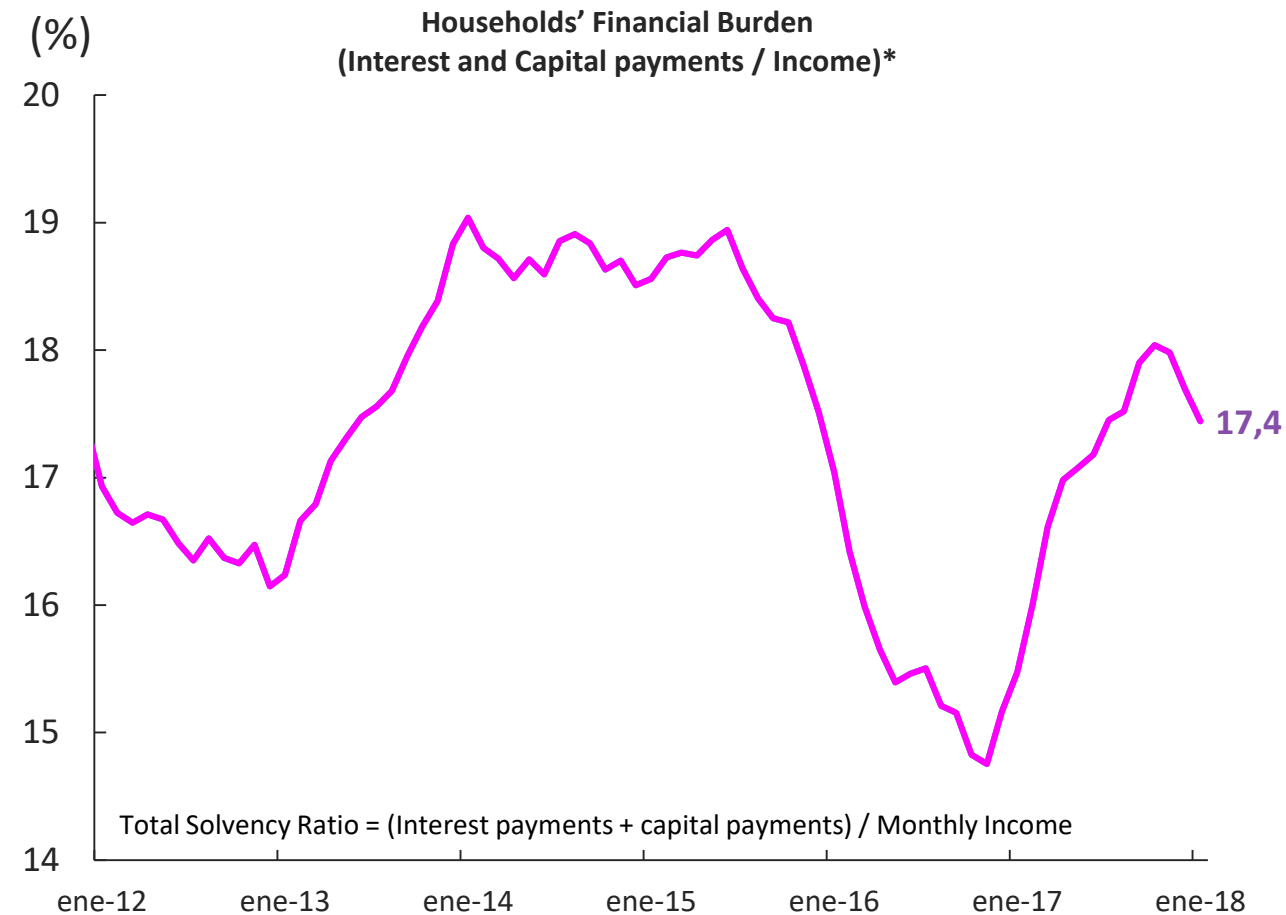
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Debt levels have increased but remain below critical levels.



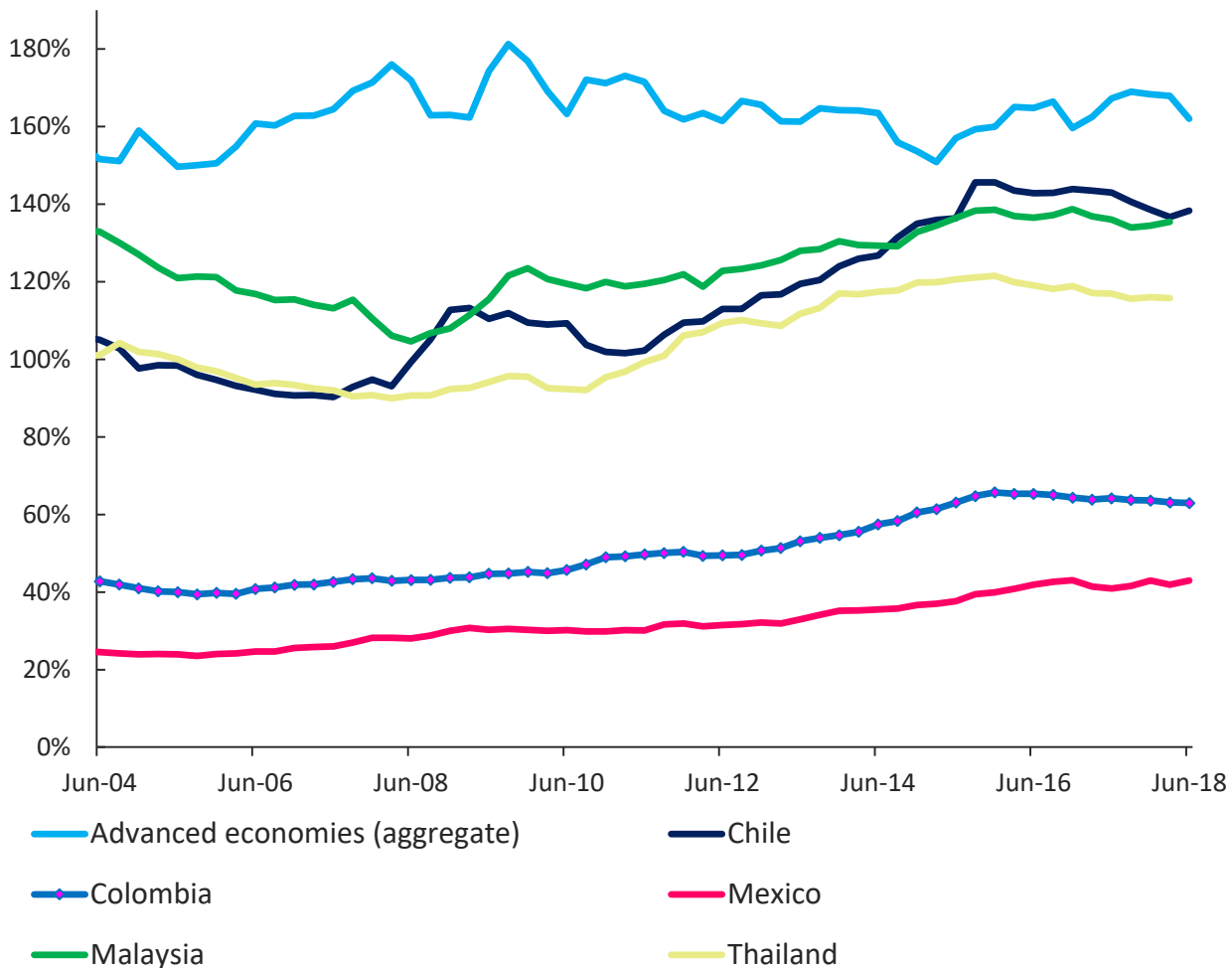
Source: Superintendencia Financiera. Calculations by Banco de la República



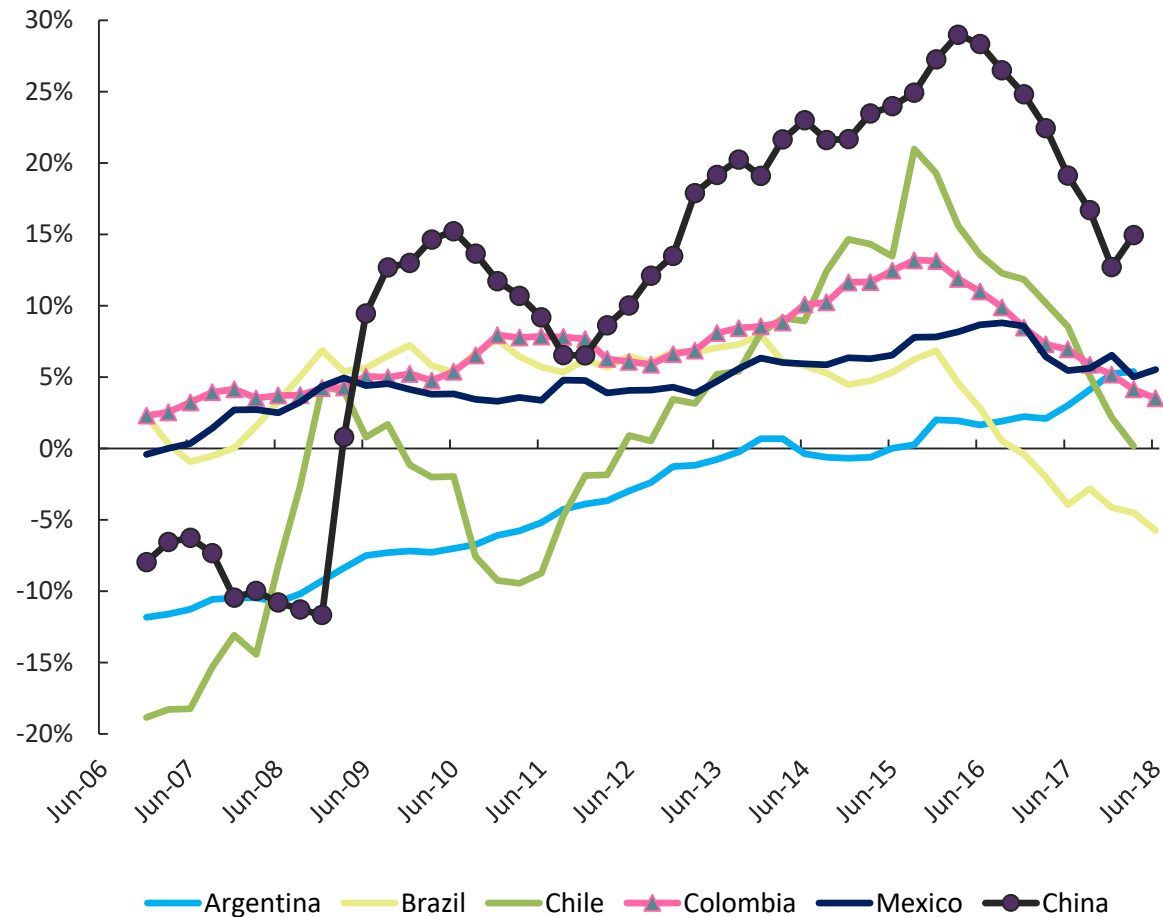
*Annual Moving Average (30% is considered risky and 40% vulnerable)
 Source: Banco de la República

Debt levels in Colombia have increased in last years but the size of the credit expansion is below international averages. Financial depth is still low relative other EME.

**Total Credit to Non Financial Private Sector
(Ratio to GDP)**



**Credit-to-GDP Gap
(actual-trend)**





Thank you
