The central bank response to the current crisis and future policy challenges

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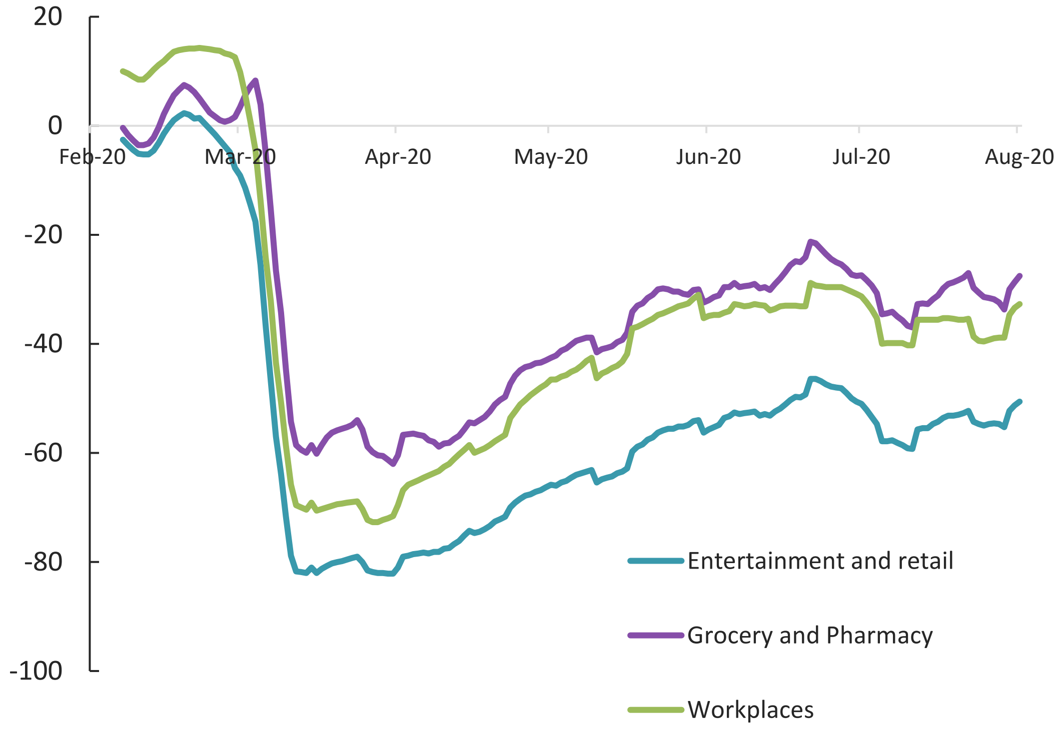
October 22, 2020

*The opinions presented here do not represent the position of the Board of Directors

Content

- **The Colombian economy is facing an unprecedented shock** because of isolation measures and the drop of international commodity prices.

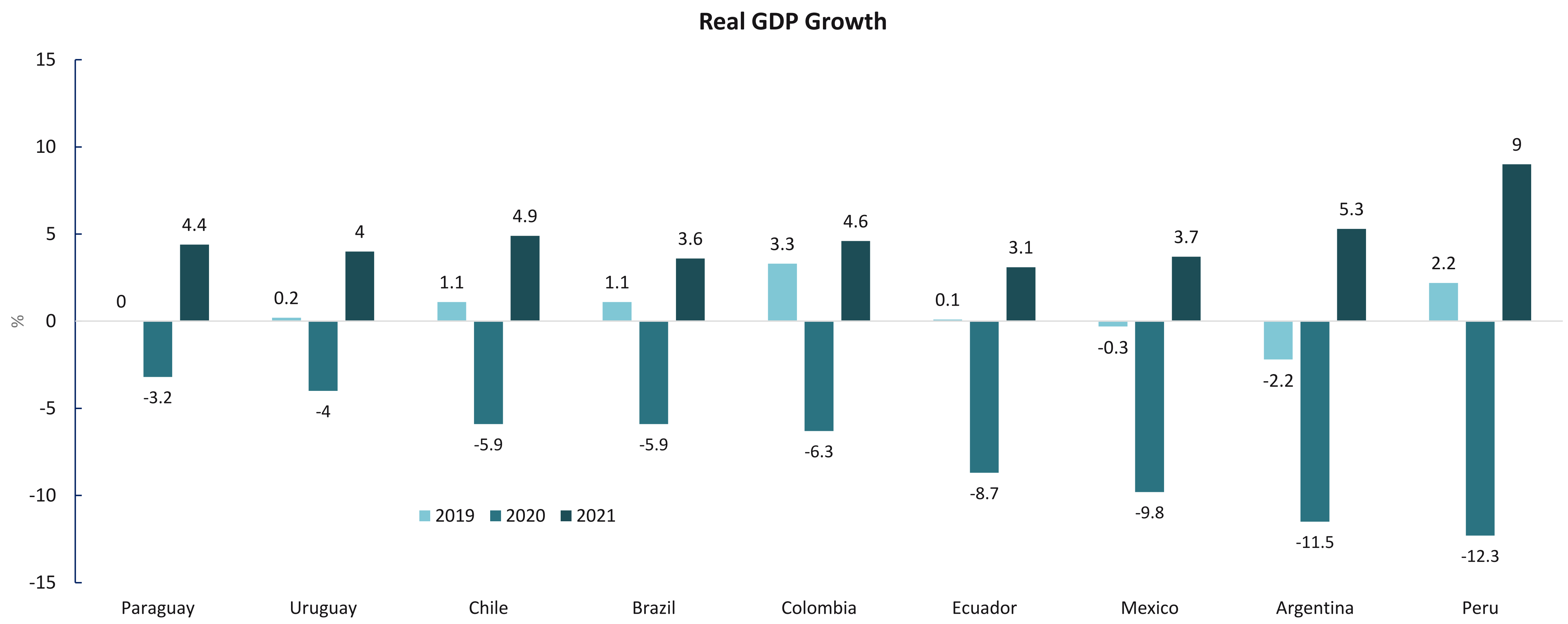
Google Mobility Trend – Colombia
(percental change from baseline)



Commodity prices
(January 2020 = 100)

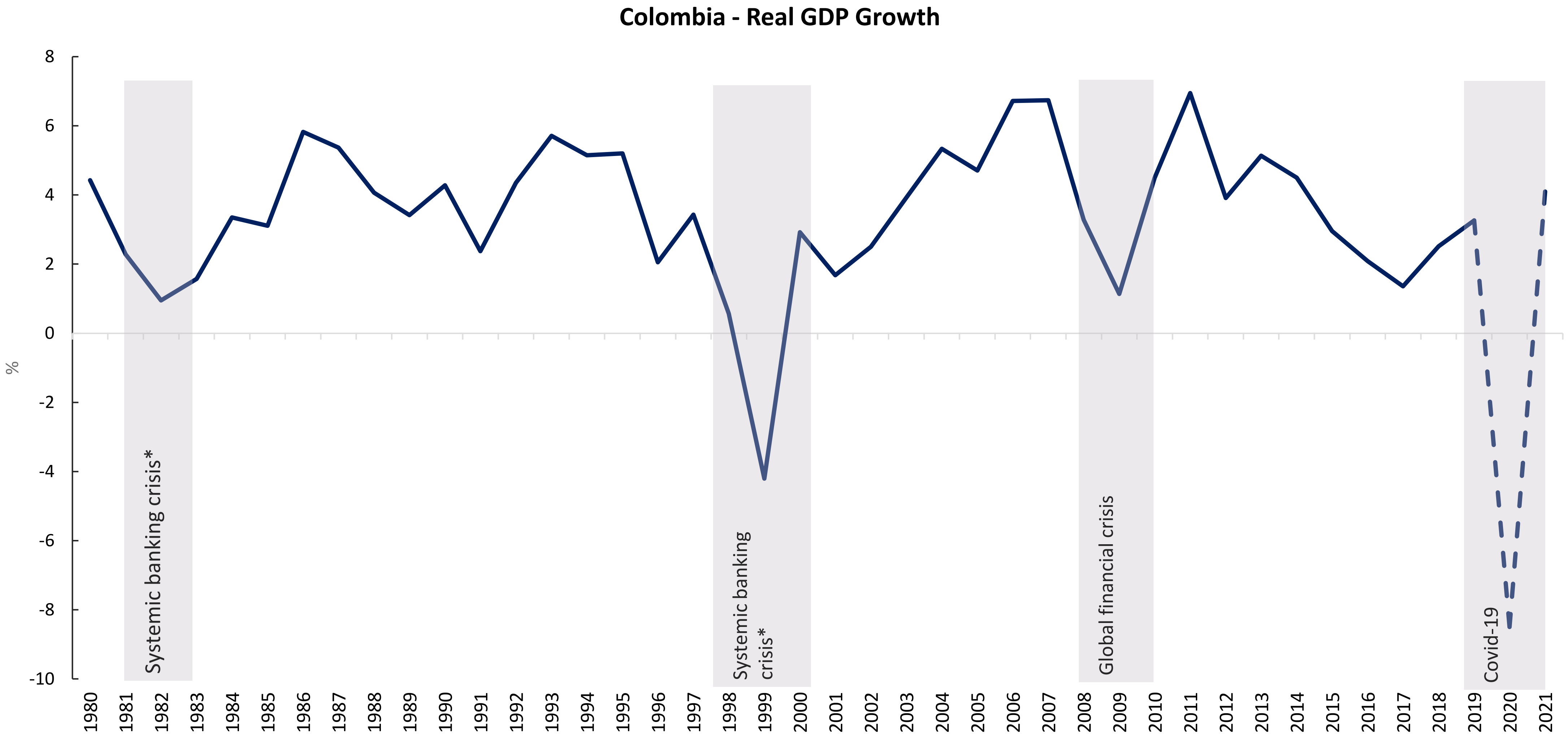
Source: Bloomberg y Google

- Analysts expect a contraction of 7,6% in real GDP in the region this year.



Source: Latin American Consensus Forecast- September 2020

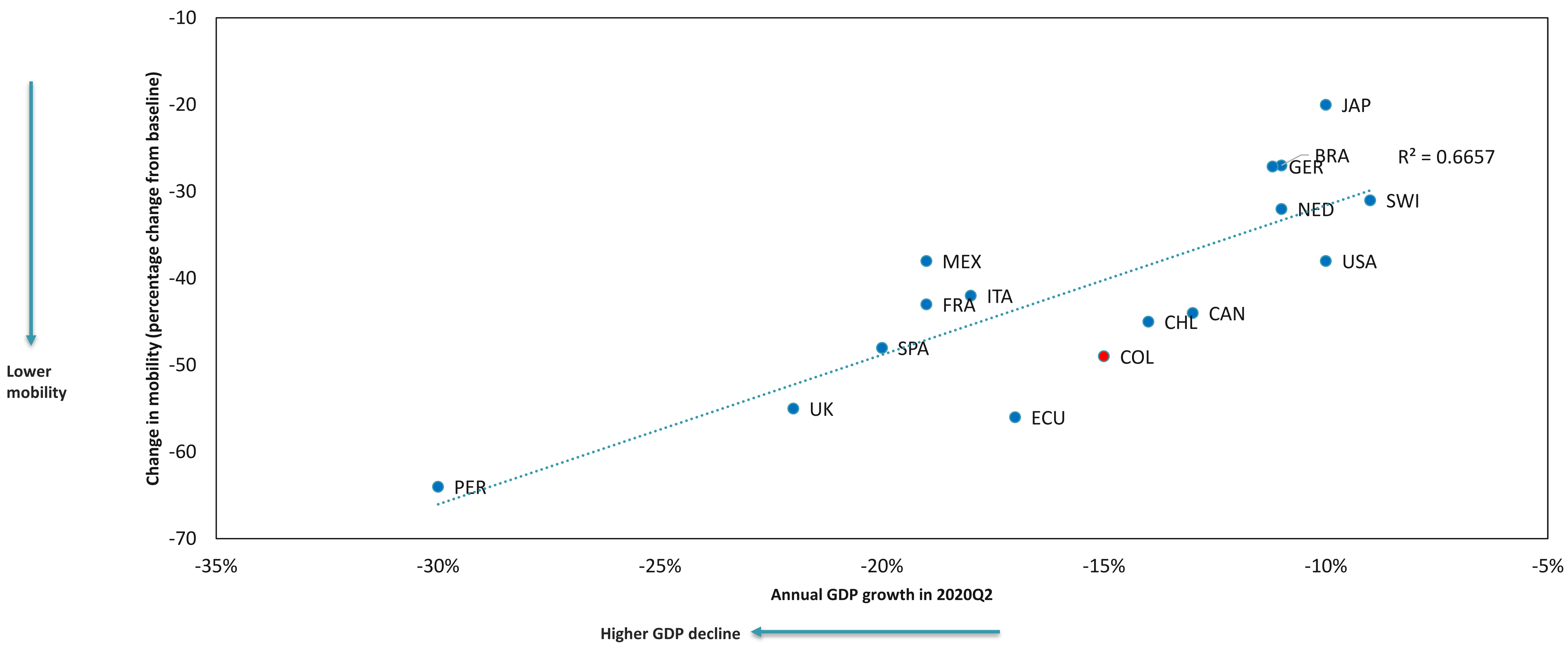
- **The Colombian economy will suffer an unprecedented recession.**



Source: IMF. *Crisis periods obtained from Laeven y Valencia (2018). Banrep's forecasts for 2020 and 2021.

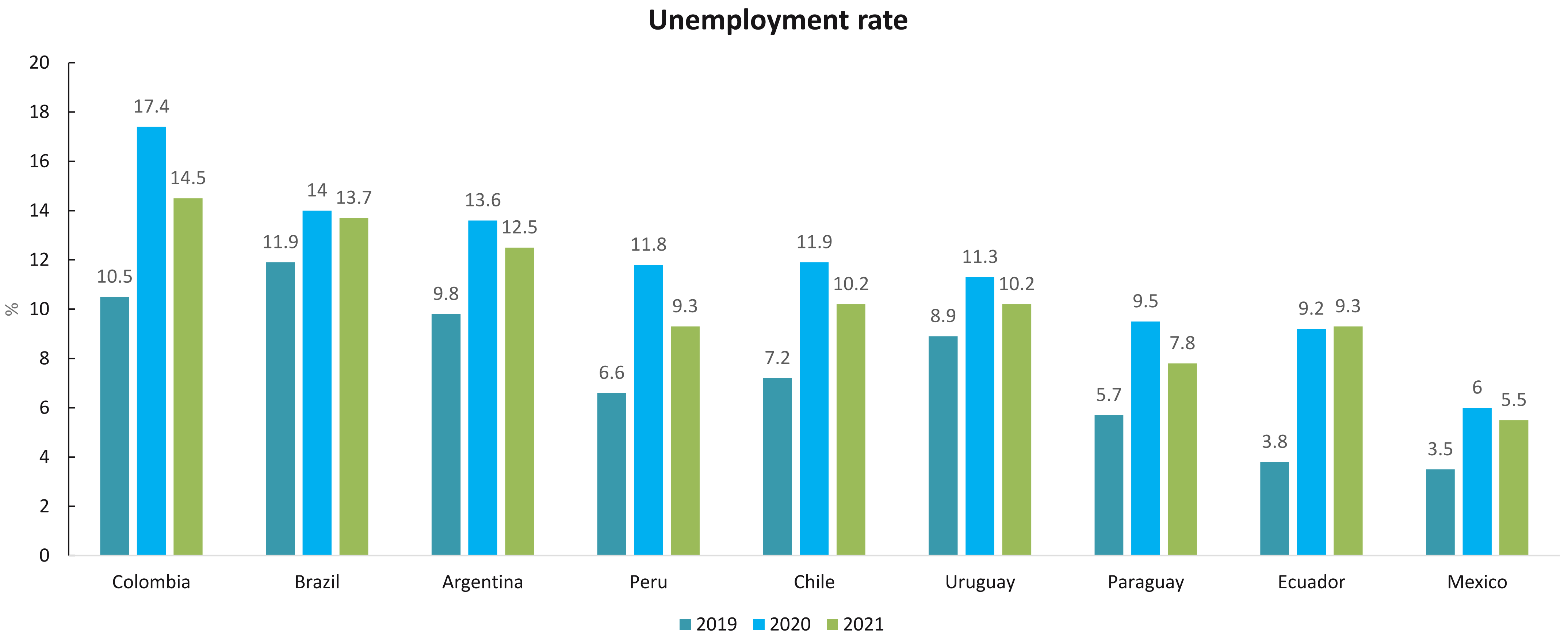
- The intensity of the recession is explained by the public health measures to minimize the spread of the virus.

Mobility to workplaces and GDP growth in 2020-Q2



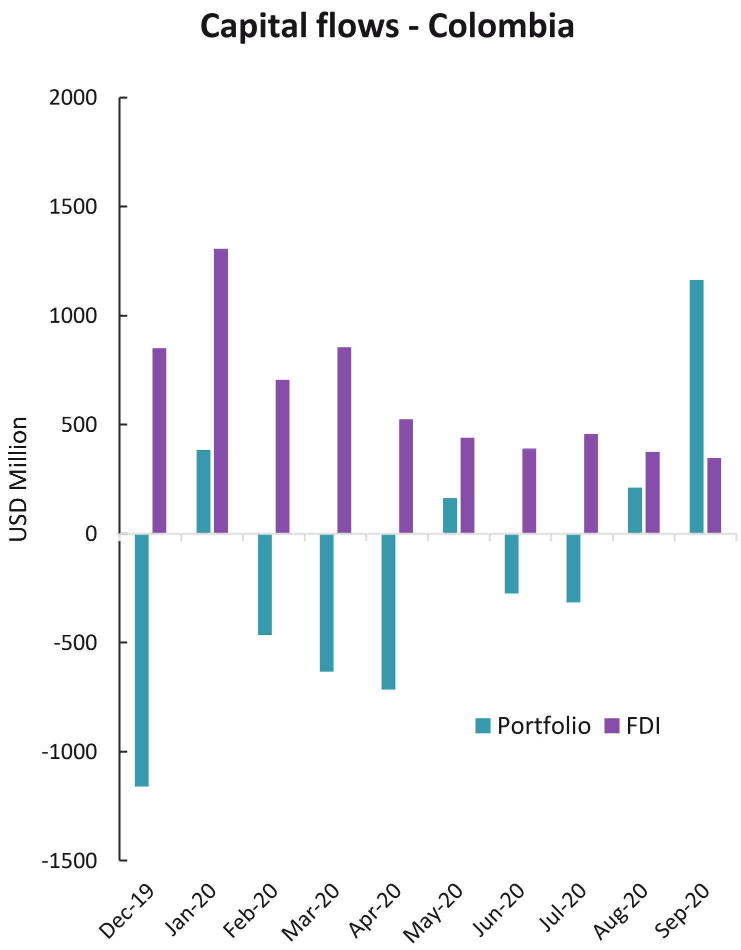
Source: Google, Bloomberg and central banks

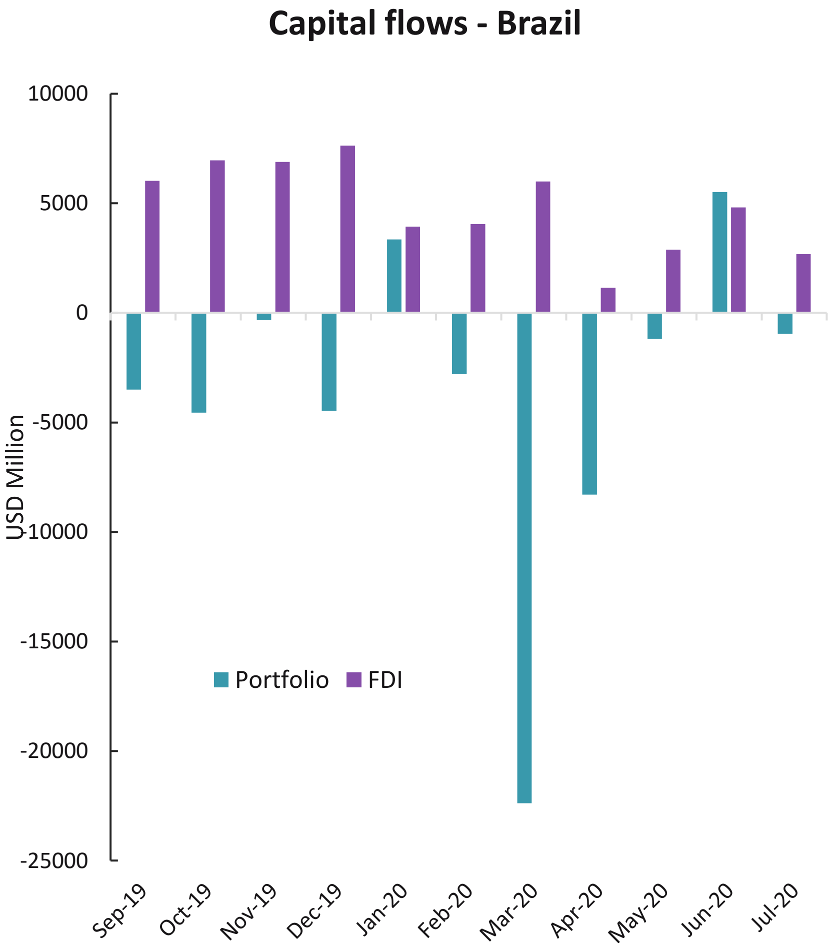
- **Major effects on the labor market.** The economic rebound expected for 2021 won't be enough to recover the unemployment levels observed in 2019.

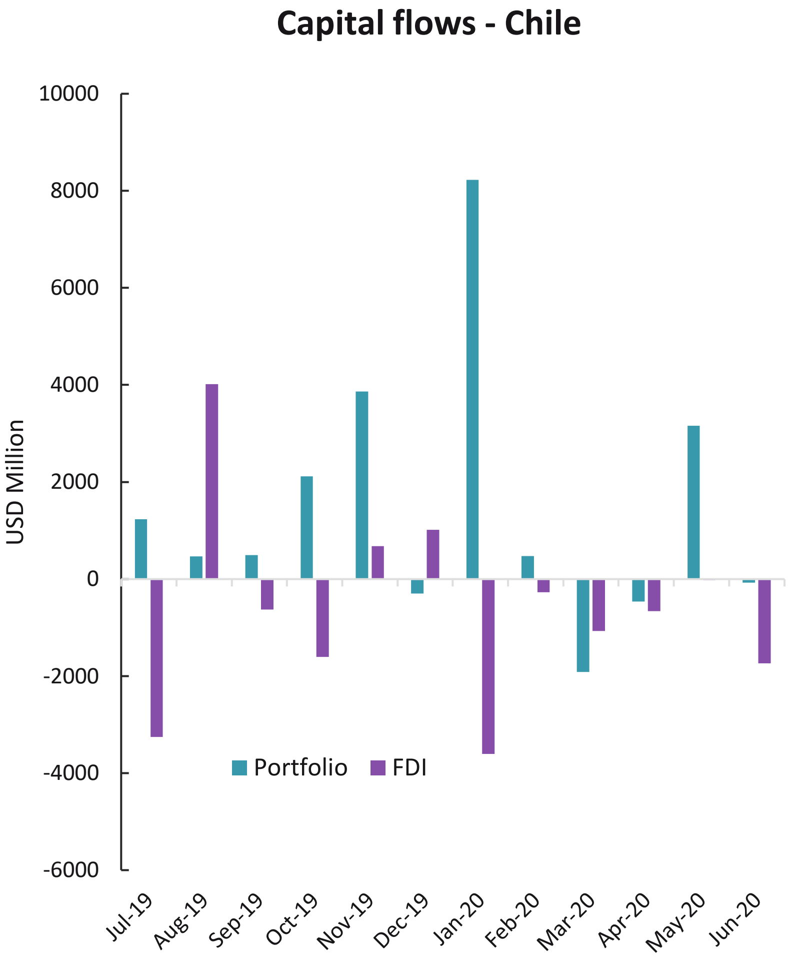


Source: Latin American Consensus Forecast- September 2020

- **The volatility and illiquidity of financial markets in March was accompanied by portfolio outflows.** There has been a correction in financial outflows in recent months.



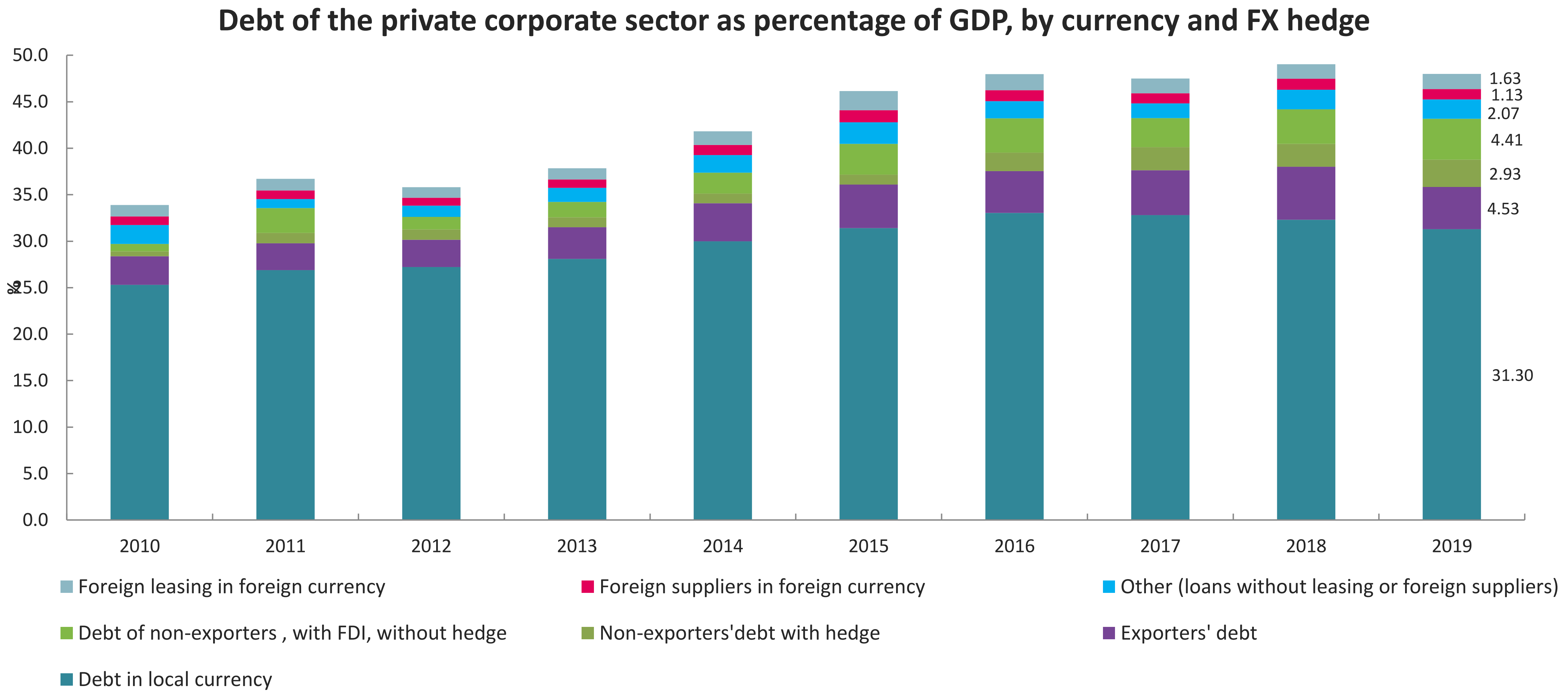




Source: Banco de la República (balanza cambiaria) and Institute of International Finance– Includes debt and equity flows

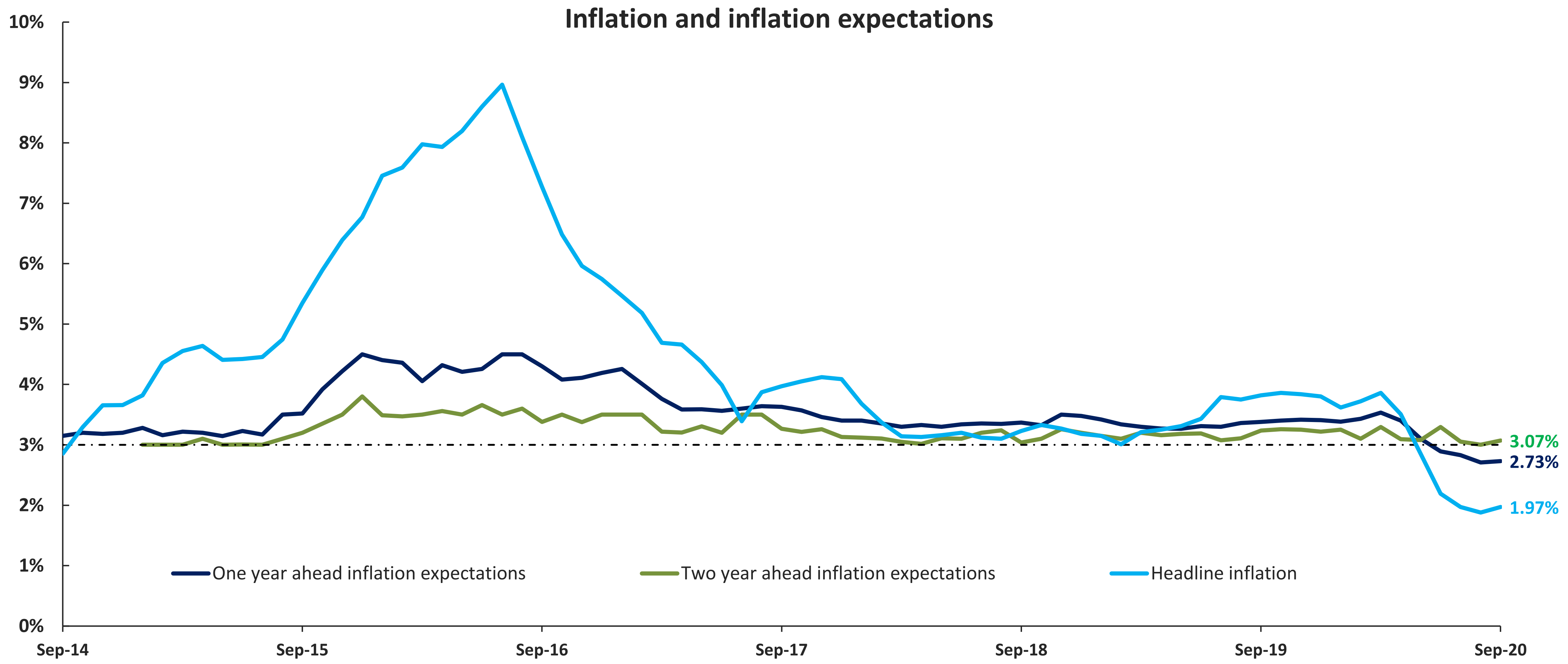
- The monetary policy framework and other characteristics of the Colombian economy allowed for a quick response against the shocks:
  1. The Colombian economy has a fully-fledged inflation targeting regime with exchange rate flexibility and the central bank has high credibility
  2. Fiscal policy is anchored in the medium term
  3. Adequate level of external buffers
  4. There is an adequate financial supervision and regulation
  5. Currency mismatches are low

- **Low currency mismatches allowed for a depreciation of the Colombian peso without creating financial stability concerns.**



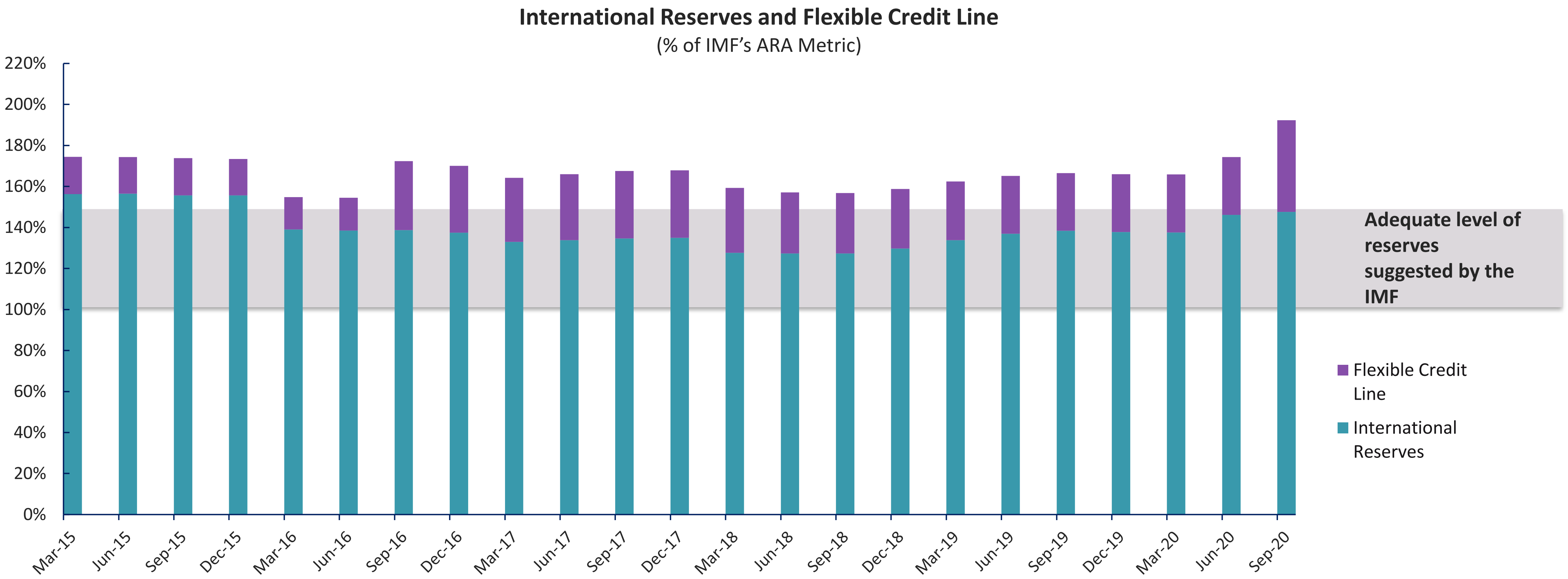
Source: Banco de la República – Financial Stability Report 2020-I

- **Thanks to its high credibility the central bank was able to react strongly to the shocks.** Inflation expectations remain close to the target.



Source: DANE and Banco de la Repúlblica (Monthly survey of economic expectations)

- **Colombia's external liquidity is adequate.** It was improved through the direct purchase of USD 2 billion from the National Government and the augmentation of the Flexible Credit Line with the IMF to USD 17.2 billion. Furthermore, the central bank has access to the FIMA facility offered by the Federal Reserve.



Source: Banco de la República

Augmentation of the FCL

- **Not only are the magnitude and duration of the pandemic shock larger than estimated in early May when the current FCL arrangement was renewed, but also external risks and uncertainty about international economic conditions are greater.**
- **In this uncertain global environment, it was key for the country to bolster external liquidity and diversify external financing sources**. The FCL augmentation to 600 percent (SDR 12.26 billion or approximately USD 17.2 billion) will help Colombia insure against external risks by bolstering its international liquidity position.
- **The Colombian authorities intend to draw a portion of the augmented FCL for budgetary support.** The Colombian Government is planning to make a purchase of up to 187.5 percent of the country’s quota (around USD 5.3 billion) from the facility, as part of its financing plan for fiscal year 2020. **The bulk of the FCL (at least SDR 8.5 billion or approximately USD 12 billion) will, as in the past, remain precautionary.**

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The central bank has used its toolbox to support the economy by:

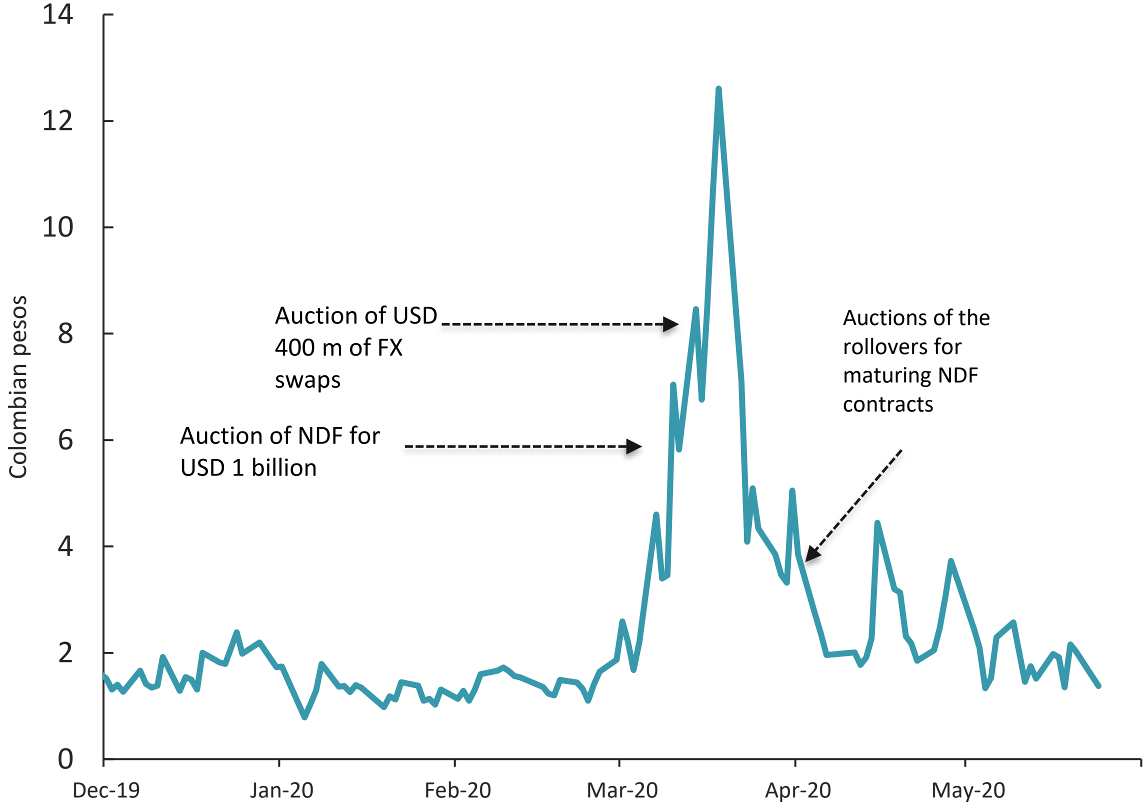
- **Providing liquidity** to avoid disruptions in the payment systems and contribute to the credit supply by financial institutions
- **Helping stabilize key financial markets** suffering liquidity problems
- **Maintaining external buffers** to facilitate external payments of the economy
- **Supporting the economy** through **lower interest rates**

Central Bank Response

Objectives Actions	Protecting the payments system	Preserve the supply of credit	Stabilizing key financial markets	Provide an economic stimulus
Temporary liquidity (repo operations): Increase in the allotment counterparties, collaterals and maturities	X	X	X	
Outright purchases of public and private securities	X	X	X	
Reduction of banks' reserve requirements	X	X		X
Auction of FX Non-delivery forwards			X	
Auction of FX swaps	X	X	X	
Reduction of the interest rates		X		X

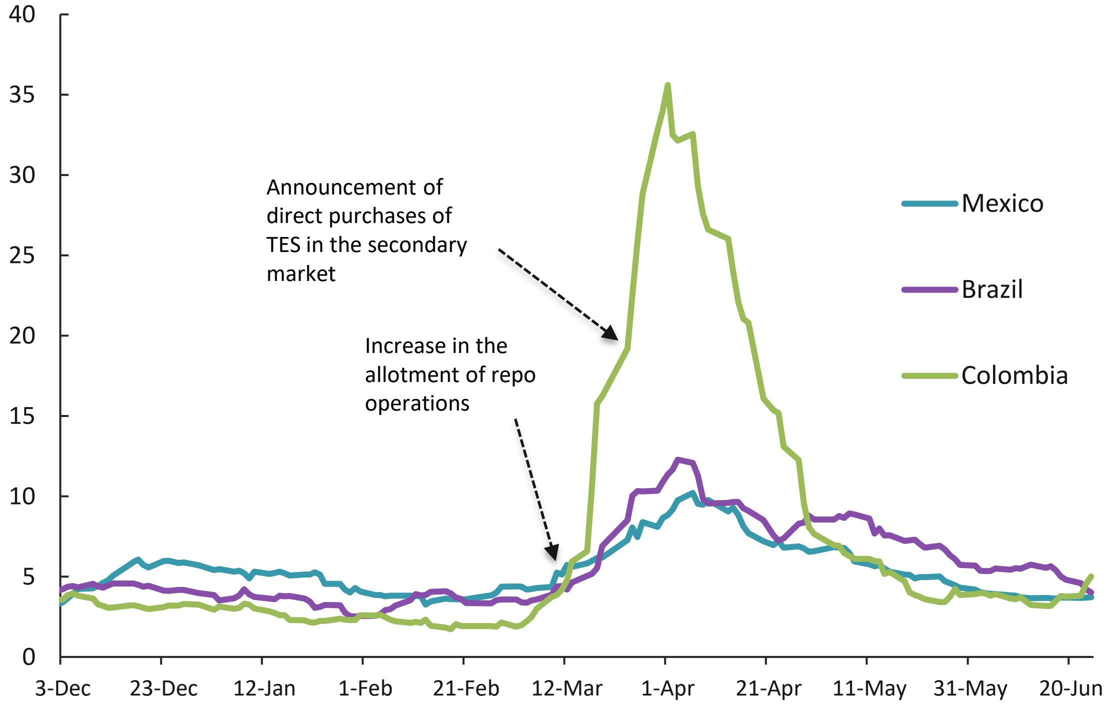
- **These policies improved liquidity conditions in the FX and local sovereign bond market.**

Bid-Ask Spread for the USD/COP exchange rate



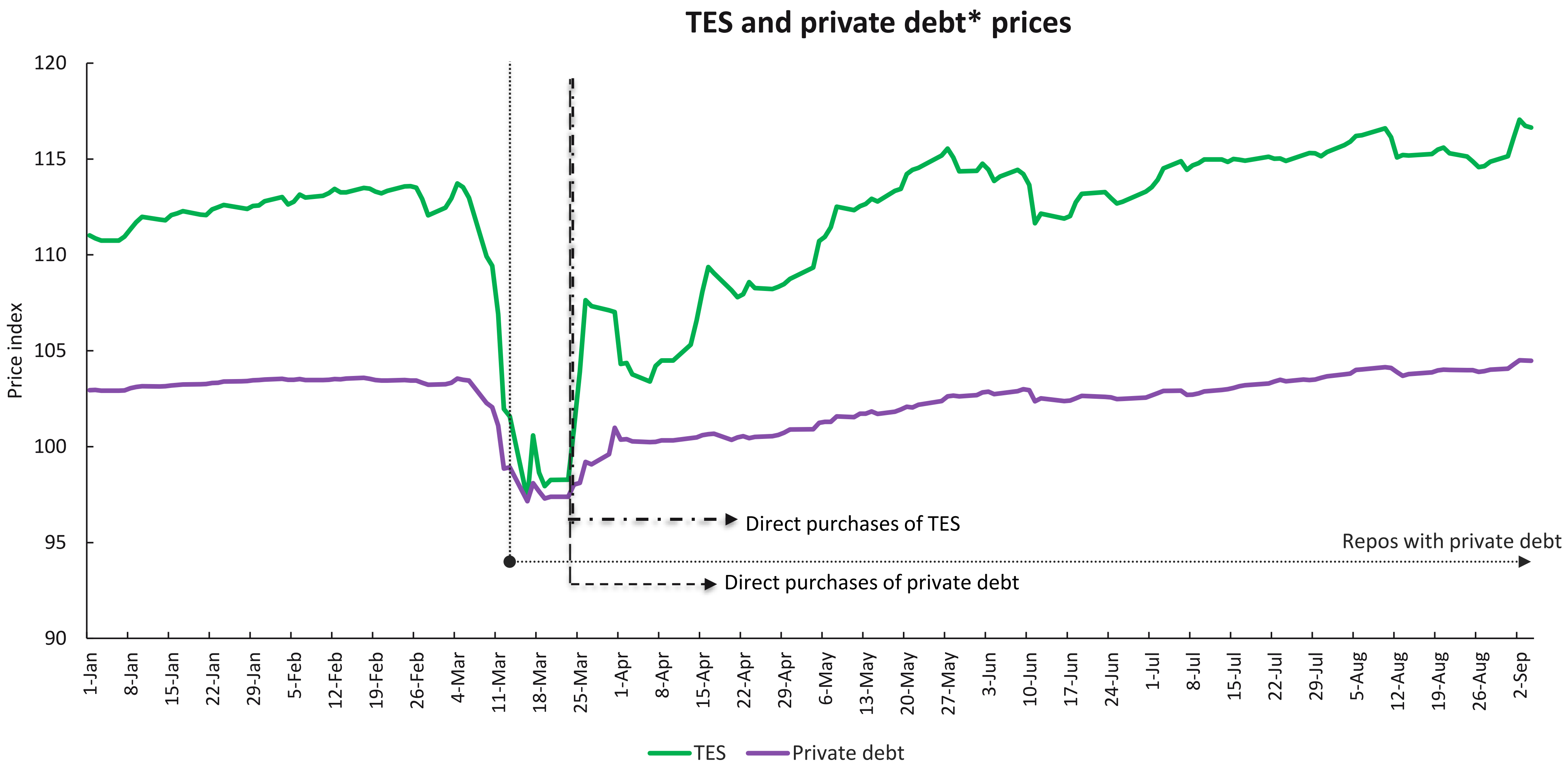
Bid-Ask Spread for 10-year sovereign local bonds in local currency*

(basis points, 10-day moving average)



Source: Banco de la República. *For Colombia TES 2028, Brazil 2029 and Mexico 2029.

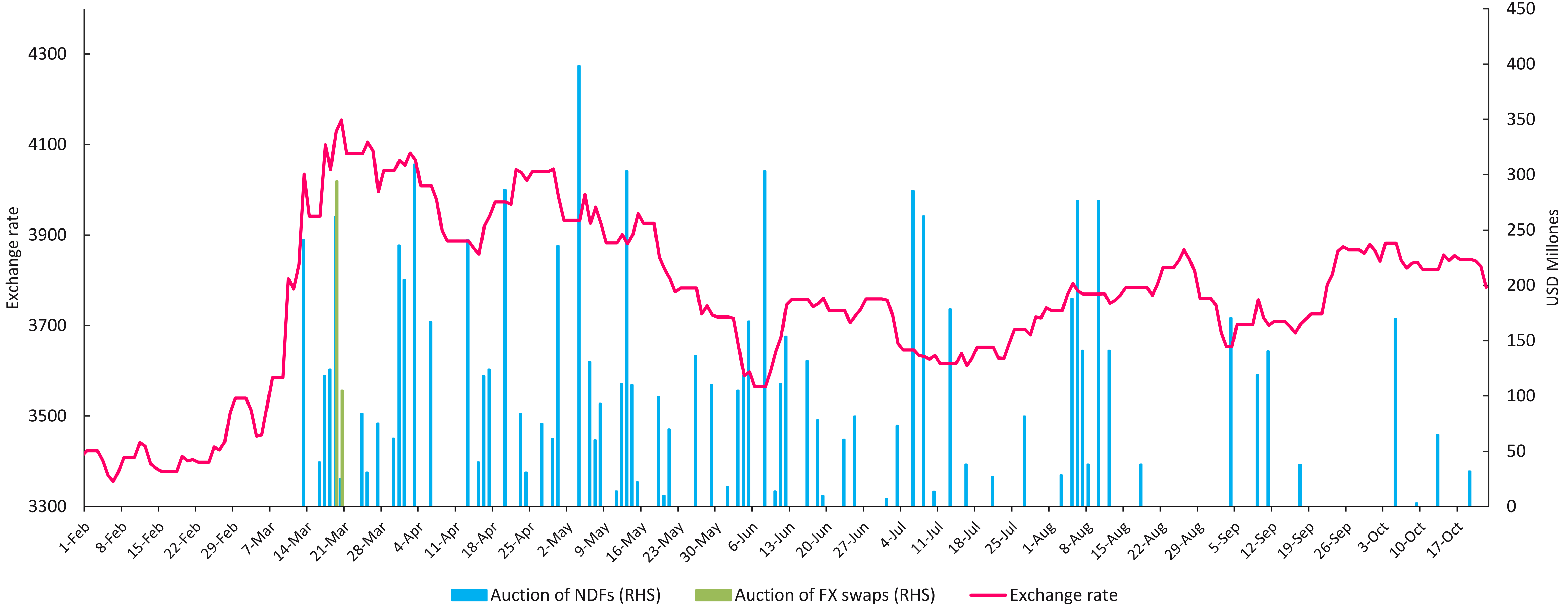
- **Interventions also preceded a recovery in the prices of private and public debt prices.**



Source: Banco de la República. * Private debt includes CDs and corporate bonds

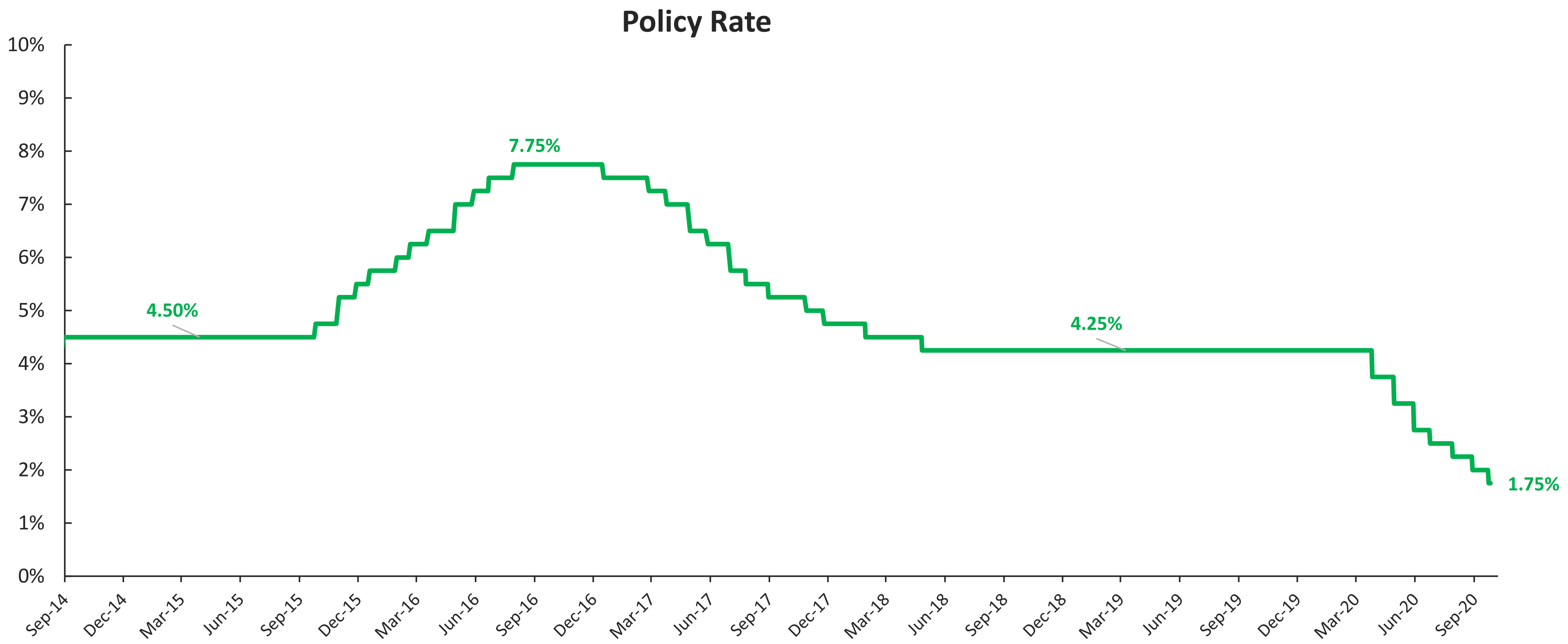
- **FX intervention provided a hedge to confront extreme market volatility.** The market has done part of the unwinding of these measures through a reduction in the demand of instruments auctioned by the central bank.

FX Intervention and exchange rate



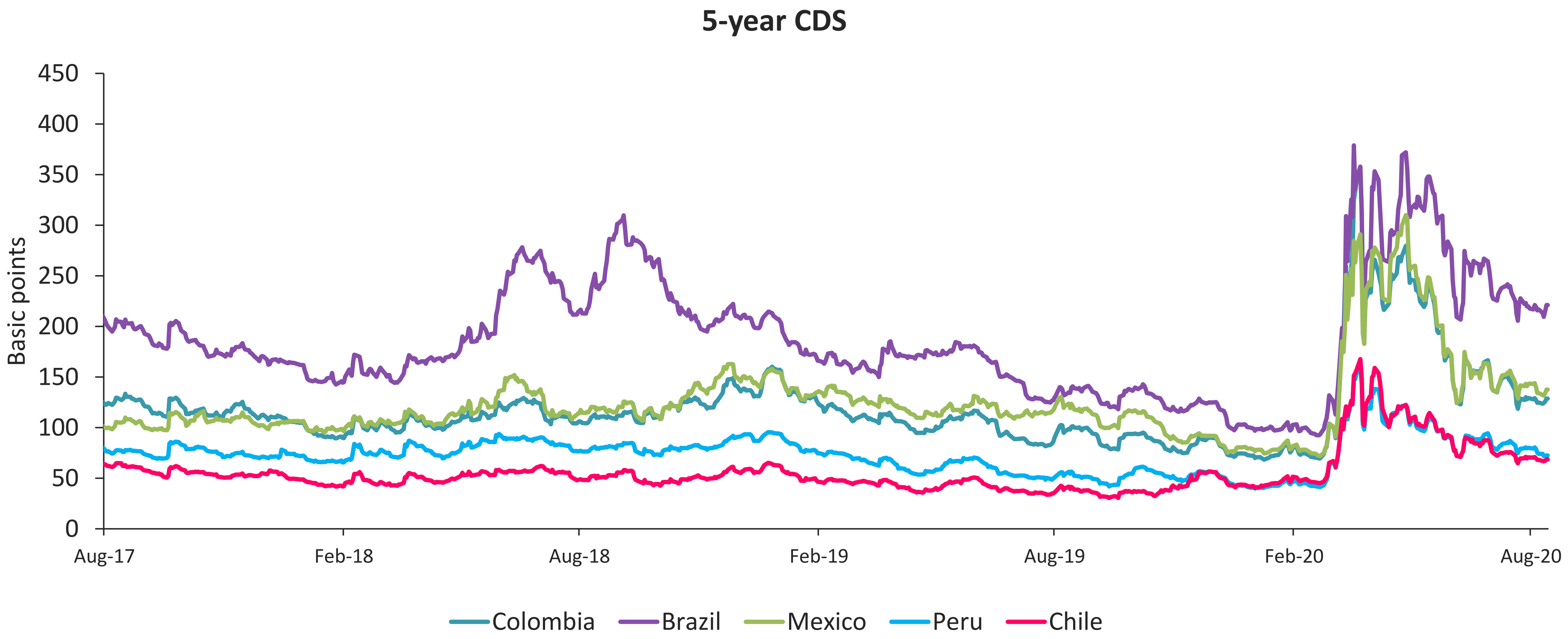
Source: Banco de la República

- **Reductions in the monetary policy rate have contributed to relieve the financial burden of debtors and reduce the cost of credit.**
- The transmission channels of monetary policy might not be working fully because of the pandemic.



Source: Banco de la República

- **External financial conditions have been an important consideration in the monetary policy rate response.** External liquidity is abundant and sovereign risk premia has fallen in recent months.



Source: Bloomberg

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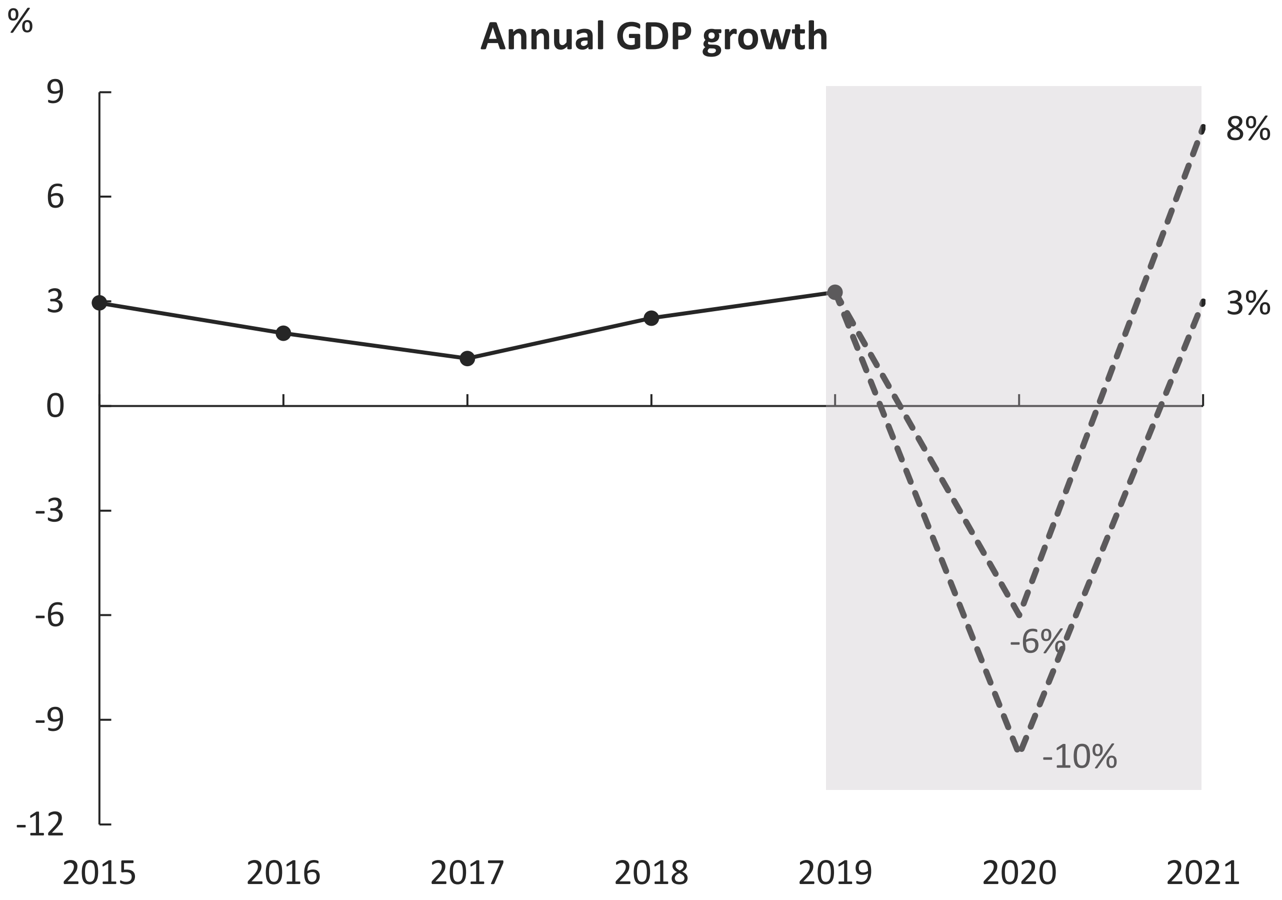
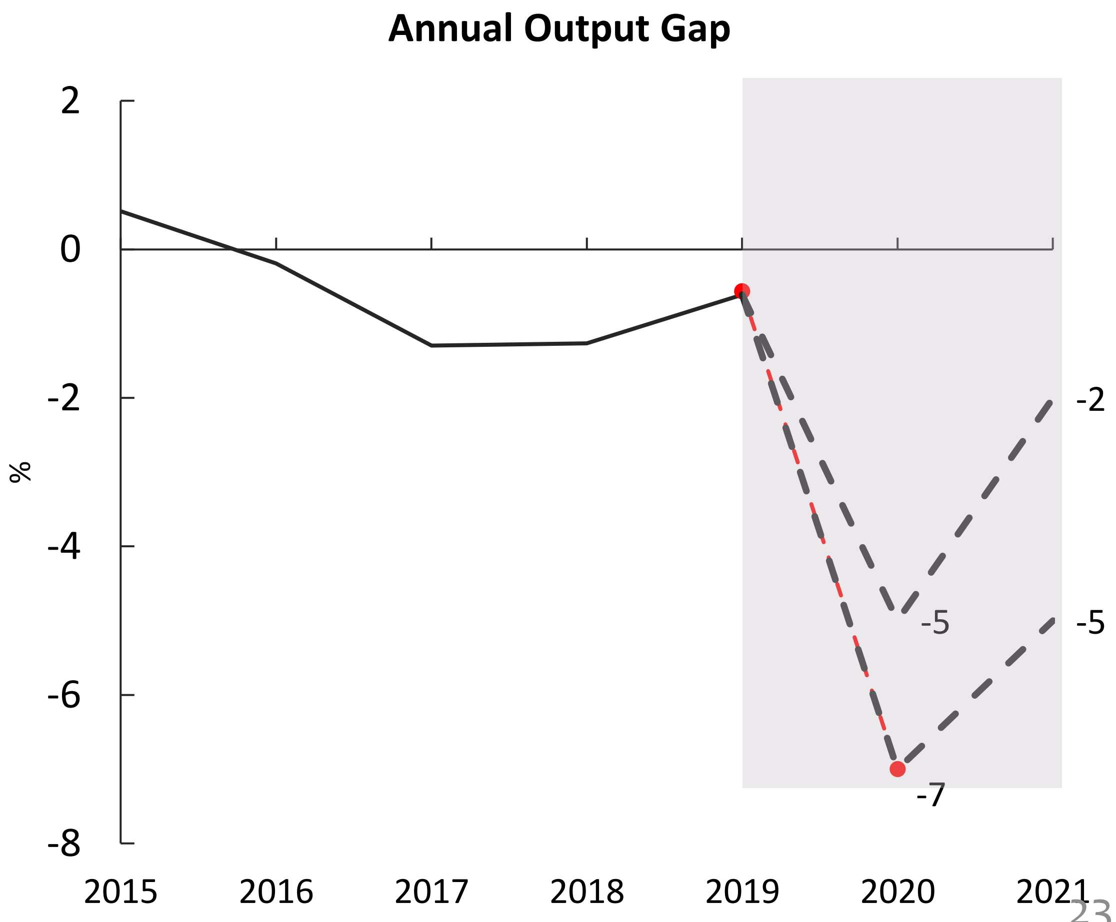
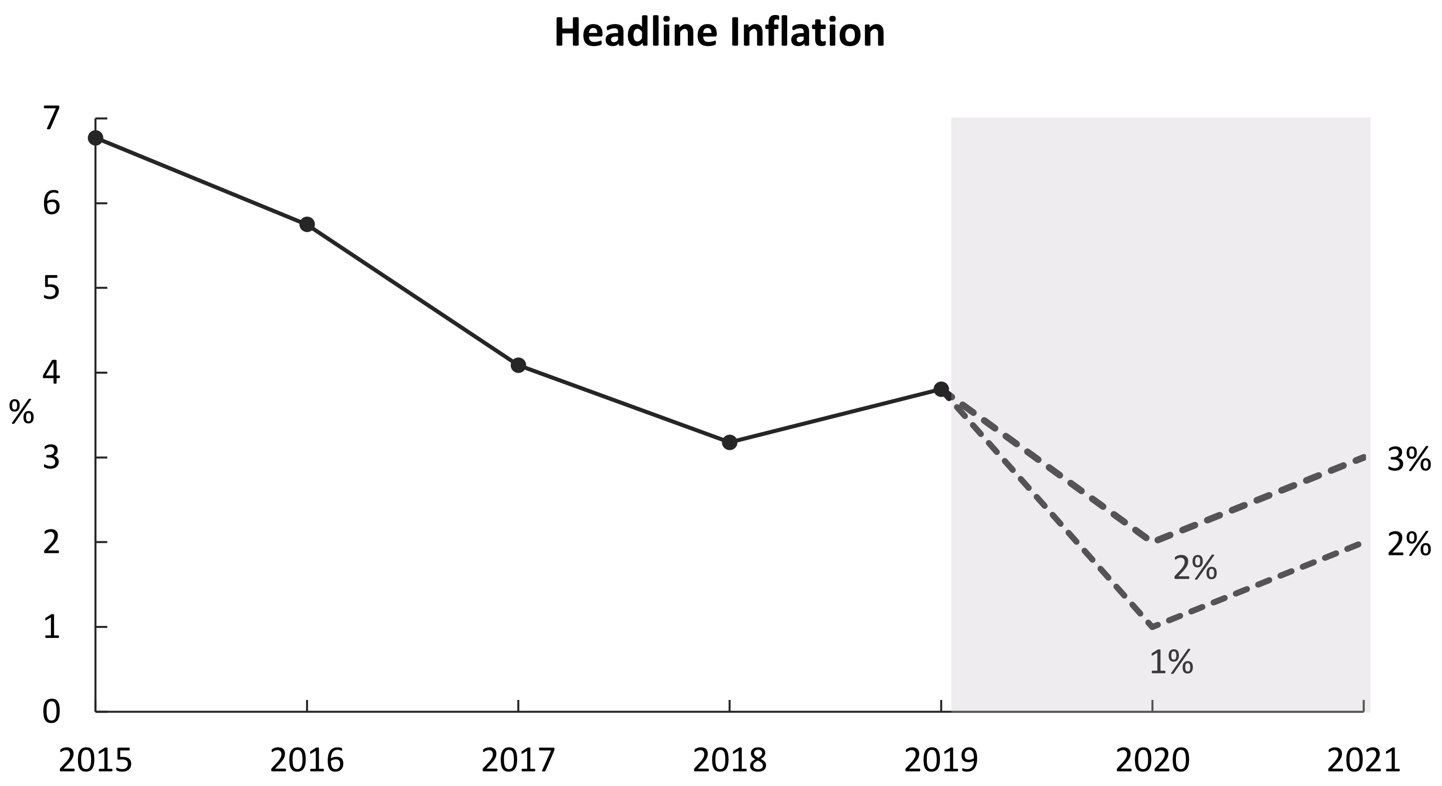
- The Central Bank' staff estimates a contraction of GDP between 6% and 10% in 2020.
- Demand effects of the shocks are expected to exceed supply effects on GDP; hence a more negative output gap is expected.





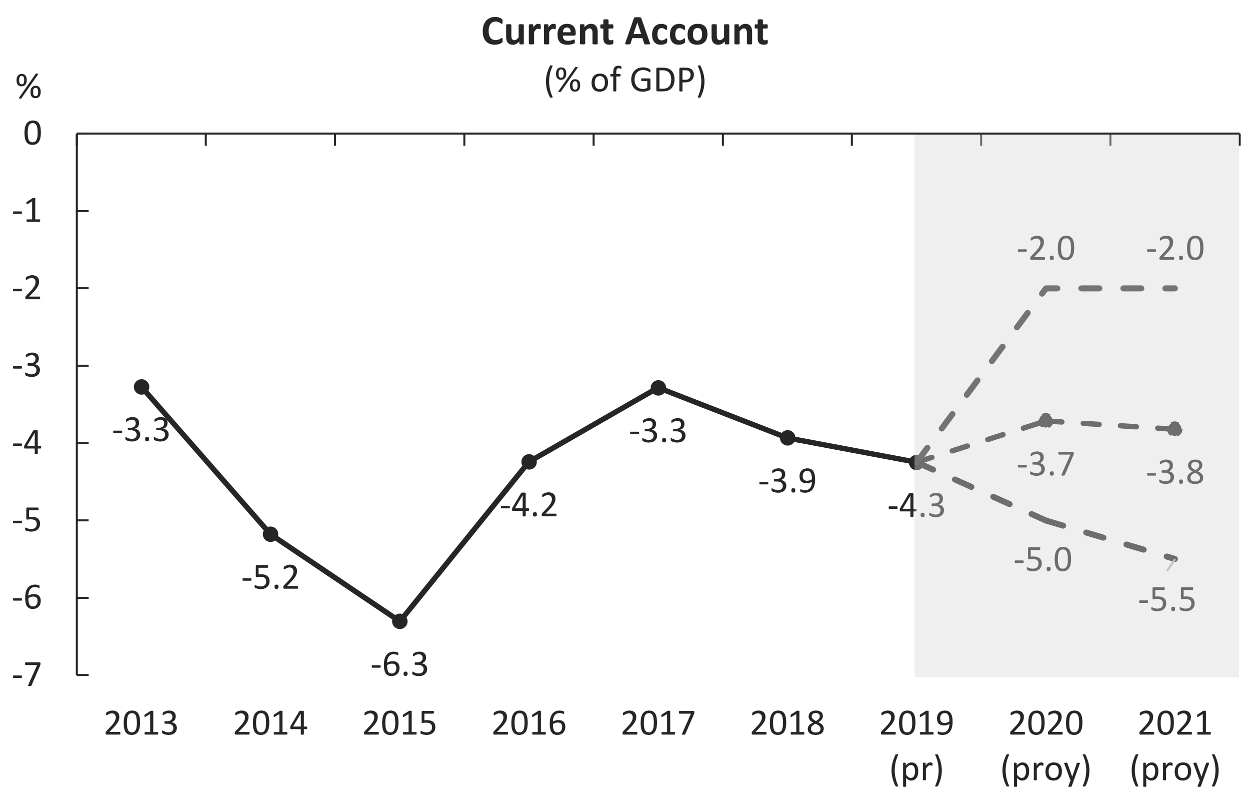
Source: Banco de la República – Monetary Policy Report

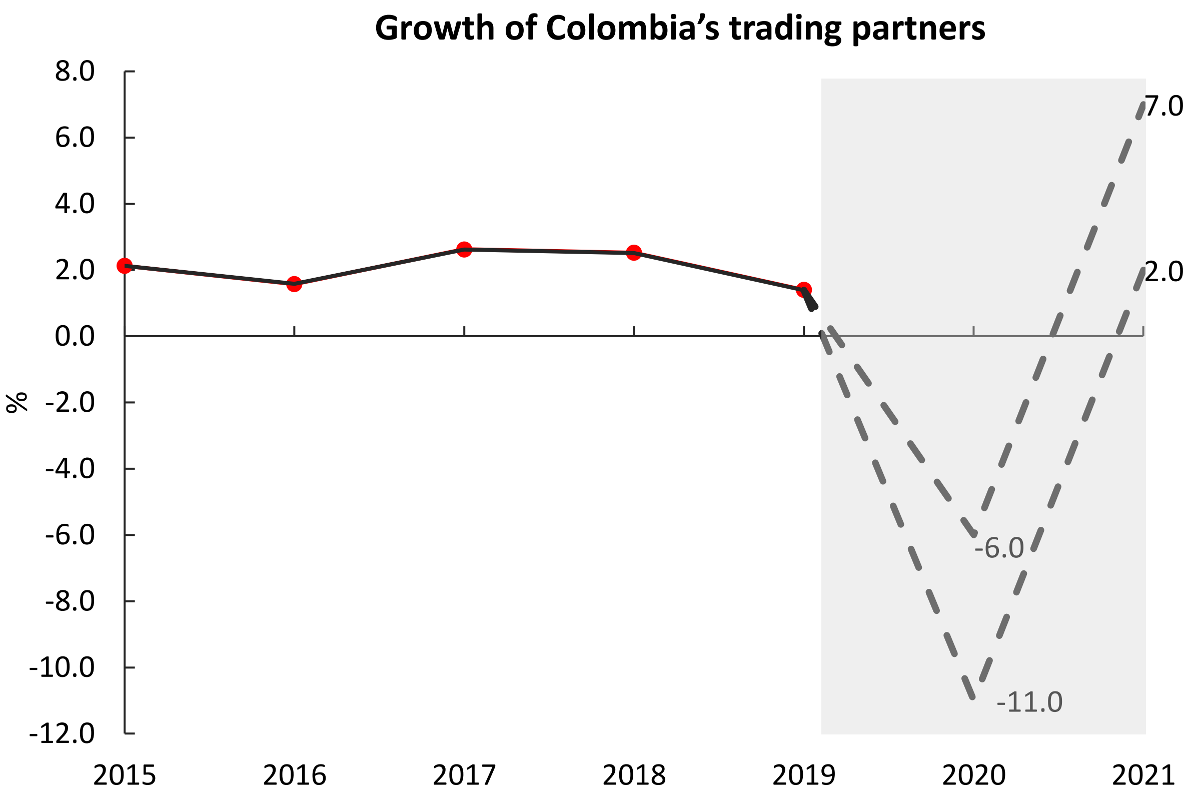
- **Because of the wider output gap and temporary relief measures, headline inflation will close the year below target.**



Source: Banco de la República – Monetary Policy Report

- **The path of the external deficit is highly uncertain, but a contraction is expected in 2020.** Lower internal demand and profit remittances would cause a reduction of the CAD, while subdued exports and worker remittances as well as the ToT shock would partially offset this movement.
- The uncertainty surrounding external demand is high.



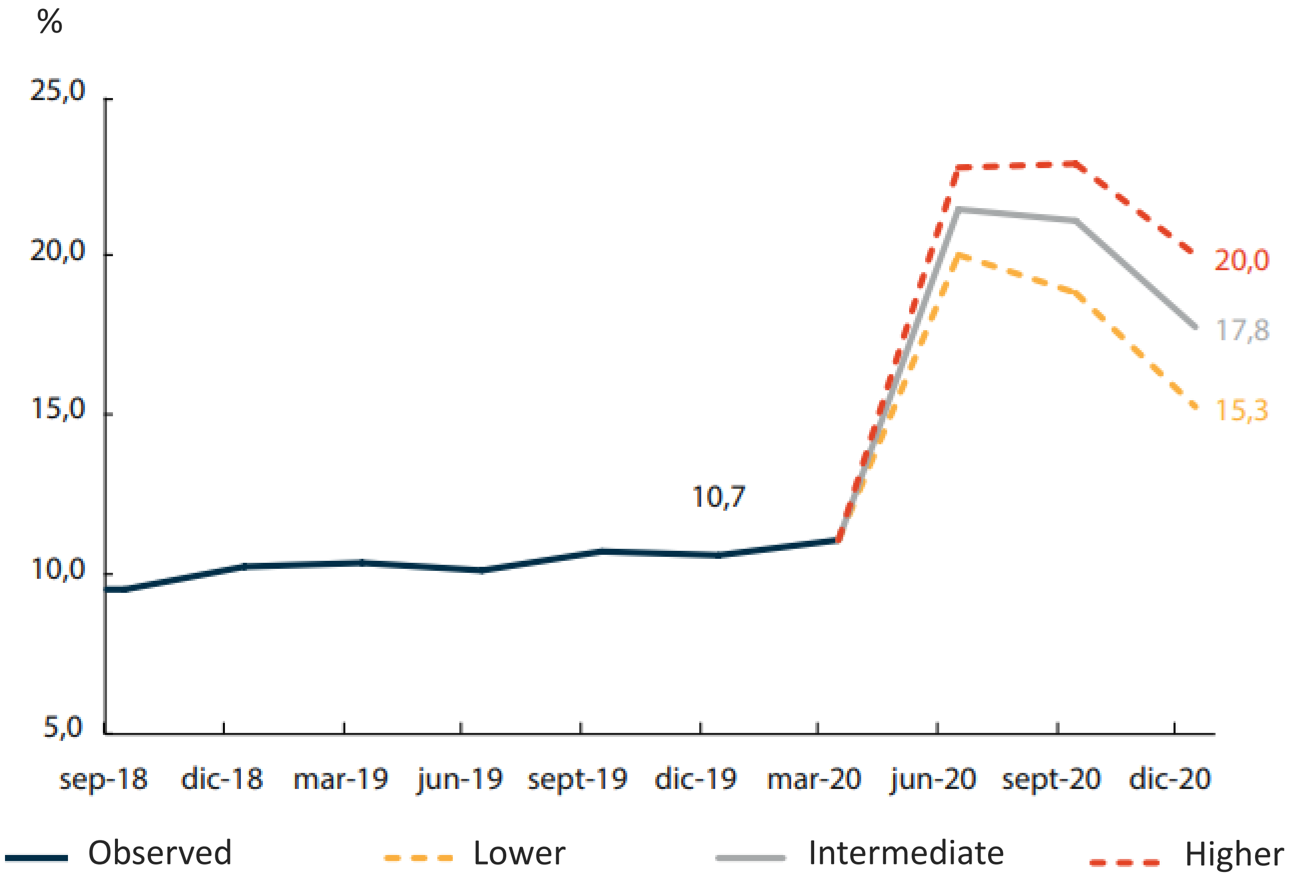


(pr): preliminary.
(proy): proyection

Source: Banco de la República – Monetary Policy Report

- **A slow normalization of employment is expected.** The rigidities in the labor market partially explain the low speed of the adjustment.

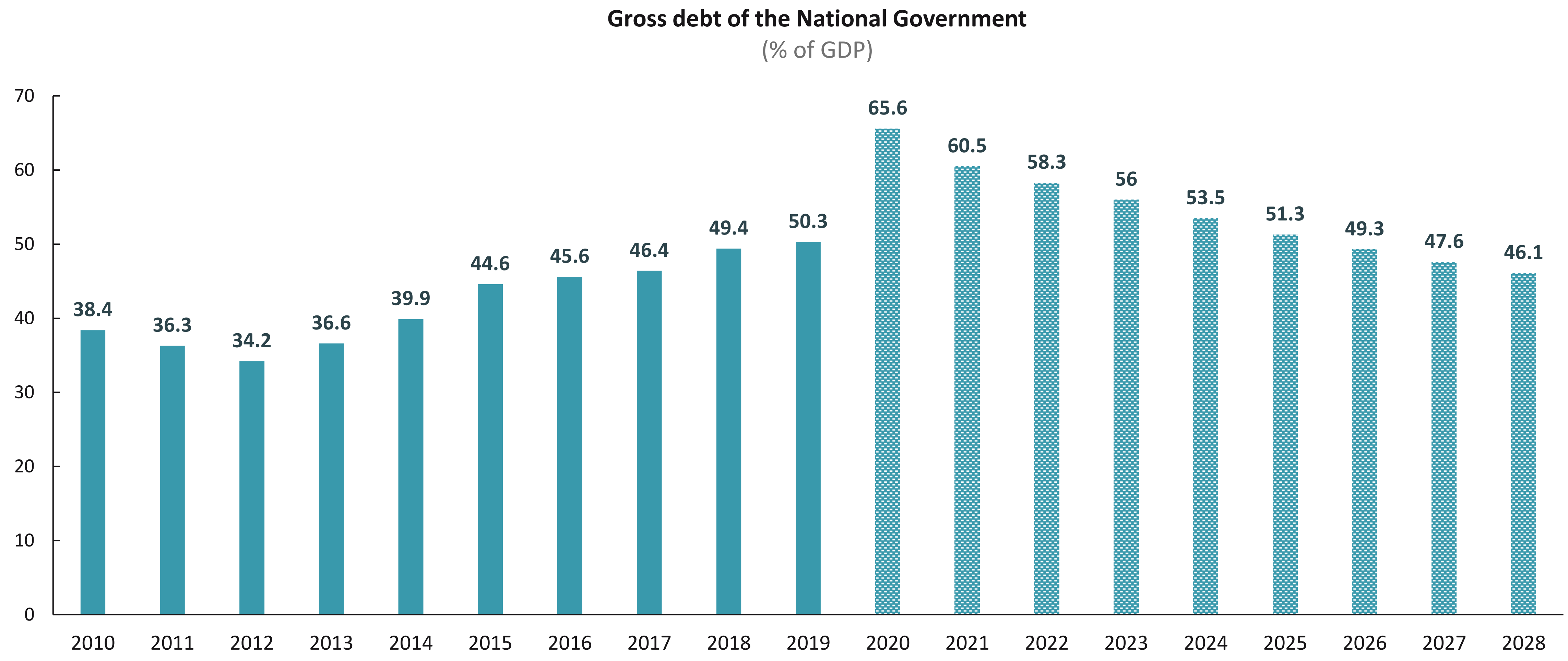
Simulations for the National Unemployment Rate



Note: seasonally adjusted series
Source: DANE. Calculations by Banco de la República – *Labor Market Report*

Content

- **In the fiscal front, the main challenge will be to maintain debt sustainability.**

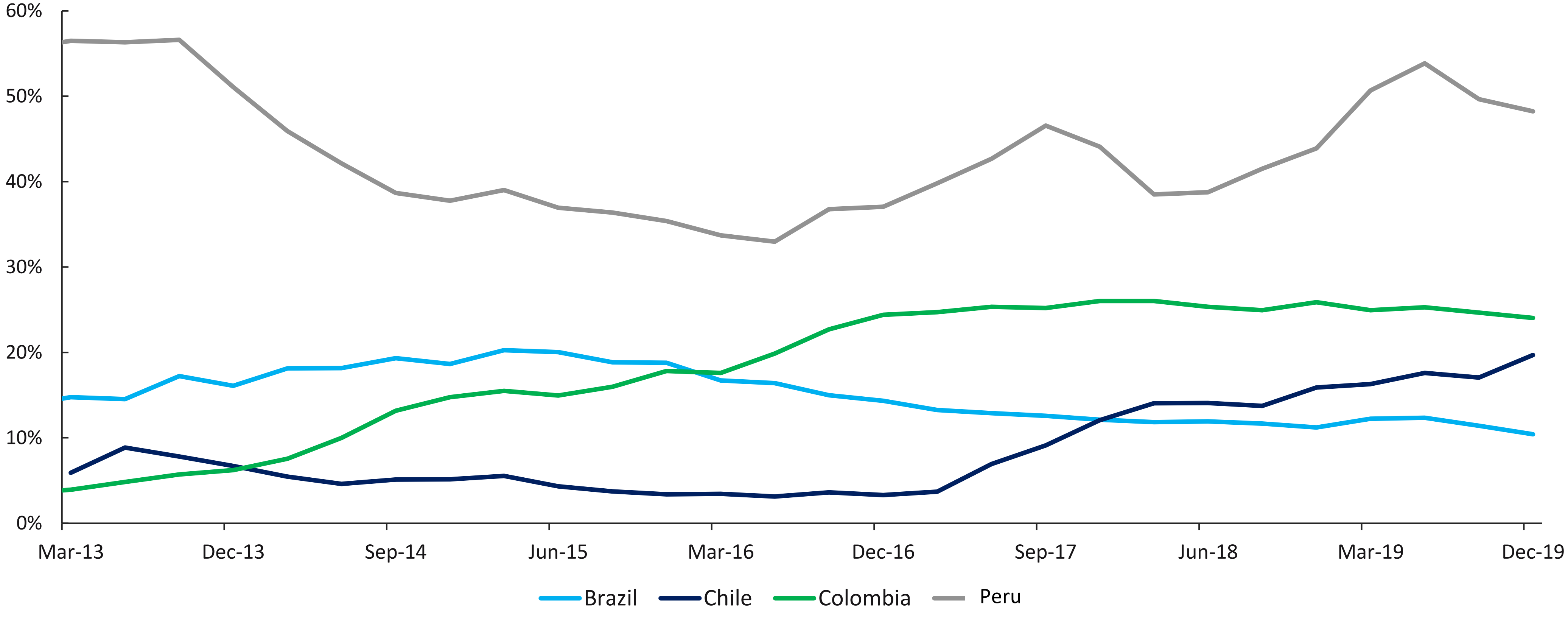


Source: Ministry of Finance – Medium Term Fiscal Framework

- **The central bank has taken a gradual approach to its monetary easing, seeking a sustainable level of stimulus to support the recovery.** There is uncertainty surrounding i) effects of the shocks on supply and demand, ii) international financial conditions, iii) public debt dynamics, iv) effects of the shocks on financial stability.

Foreign participation in the local public debt market

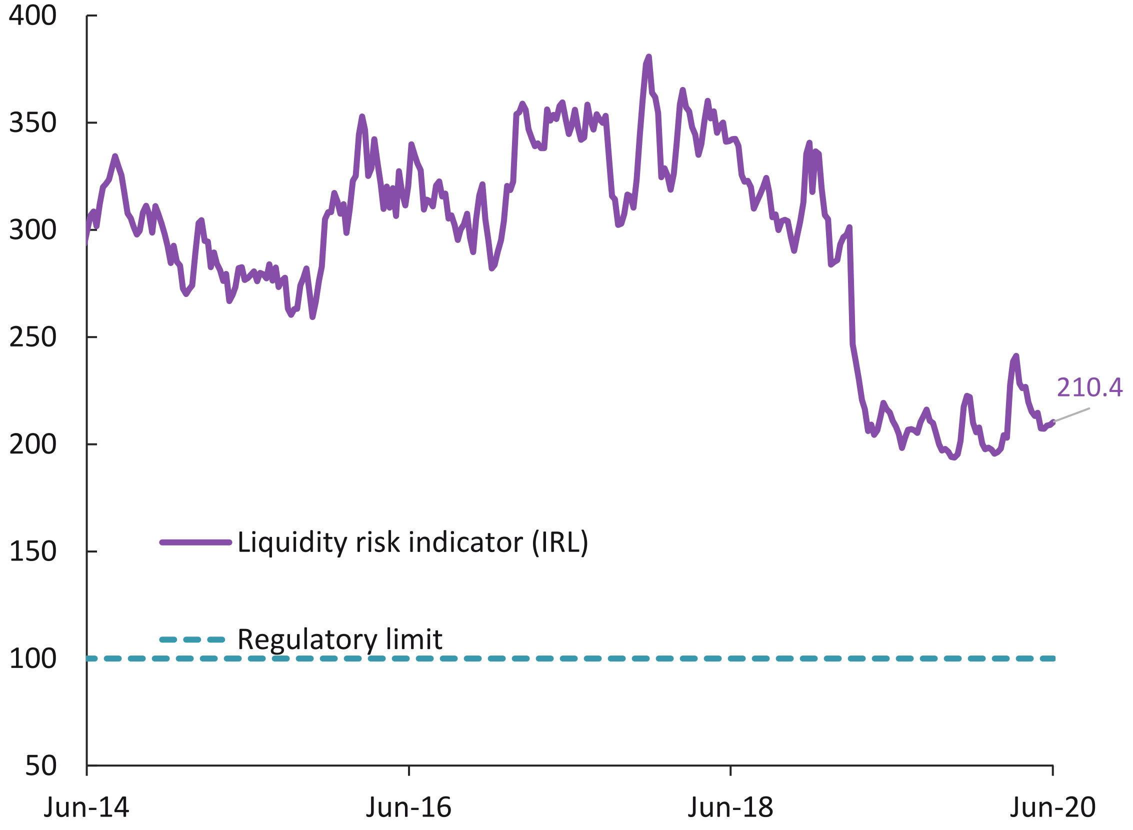
(Non-resident holdings as a % of outstanding securities)



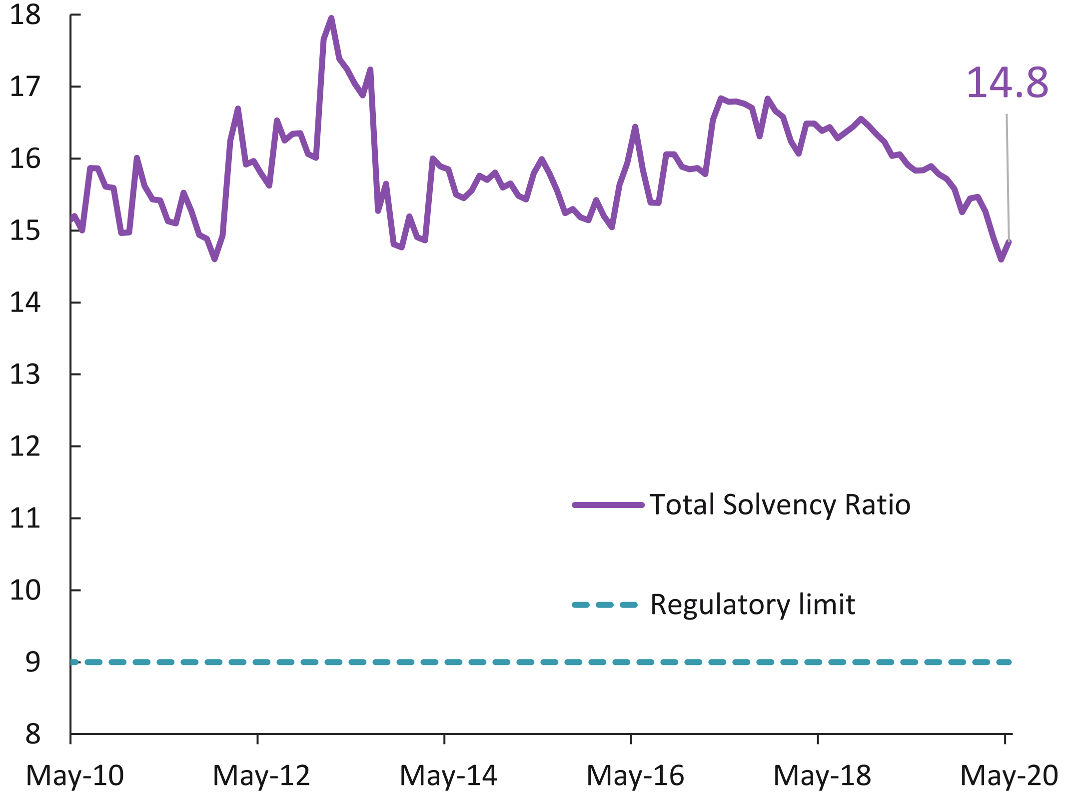
Source: Arslanalp and Tsuda (2014)

- **The financial sector faces this shock with adequate levels of liquidity and solvency.** The timeframe required for the recovery creates challenges for profitability.
- **Protracted economic weakness as a result of the shock may affect credit quality and "*Lower-for-longer*" policy rate could hinder banks' profitability and the stability of deposits.**

Liquidity risk indicator of credit establishment



Solvency ratio of credit establishments



Source: Financial Superintendency and Banco de la República