COLOMBIAN ECONOMIC OUTLOOK

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Introduction

The main purpose of this speech is to tell you about what 2009 could hold in store for Colombia's economy. I will begin by reviewing what happened in 2008 first in terms of growth and then in terms of inflation. I then will turn to the dismal prospects for the world economy in 2009, and explain how that is affecting Colombia. Our financial sector is in relatively good health and I think this will play in our favor. I want to explain the reasons behind that in the following section. I will then present my staff forecast for 2009, based on what data we have now. Finally I will close by linking this to our recent monetary policy strategy.

Growth in 2008

What stands out about Colombia's growth in 2008 is how sharply it decelerated. After growing at 6.9% in 2006 and 7.5% in 2007, our staff estimate is for it to be about 3.2% in 2008.

When we decompose this slowdown into expenditure components, we see that domestic demand growth decelerated mainly in consumption and public investment.

Some of the fall in consumption growth was due to our deliberate and prudential monetary policy actions. The Board raised the cost and restricted the supply of credit to households because we wanted to cool down the economy which was overheating. In part consumption had to slow down to some extent because it was growing too high a rate.

But the slowdown was much more acute than we expected. One very important reason for this was that there was a further bout of price increases in food and regulated goods in 2008. These sharp rises in living costs outstripped nominal income growth and choked off the purchasing power of households. As Chart 1 shows, consumption is very sensitive to real disposable income in Colombia, as access to financial markets is limited. Inevitably then, households cut back sharply in spending. The slowdown was felt in especially discretionary durable goods, such as cars.

In addition, consumption was affected by a collapse in confidence that intensified in September 2008 (Chart 2). This was probably as the prospect of a protracted world crisis sunk into peoples' minds, and the greater pessimism can be seen in surveys for other countries at that time.

All in all annual growth in consumption spending fell from the very high level of 6.9% in 2007, to 3% in the first quarter of 2008 and down further to 2% in the third quarter. Indicators suggest that this slowdown will continue into the last quarter. For example retail sales in November were growing at nearly -3% (Chart 3).

In terms of investment, the public and private components behaved very differently. Public investment fell steeply in 2008. This was because of delays in carrying out public projects by new regional administrations which just recently took office. For the same reason, then, public investment growth will very likely recover strongly in 2009.

In contrast, private investment in 2008 kept growing close to the high rates of 2007. In the first three quarters of 2008, the average growth of gross fixed capital formation was 12%, not very different to the 13.7% rate we saw for 2007.

With private investment growing at respectable rates, it was to be expected that the imports of capital goods continued to increase strongly. Imports of raw materials also grew strongly. So the only important slackening in imports so far has been in consumption goods. See Table 1.

It seems that export growth did slow down over the year, though. The real annual growth rate of exports was 1.4% in the third quarter, down from 11.3% in the first half of the year in peso terms. Most of reduction was in coal, coffee and manufactured items such as textiles in terms of products. In terms of markets, the slowdowns were mainly in goods to Venezuela and to the United States.

Up until June, we can say that the slowdown was due to the imposition of restrictions on certain exports, especially cars, to Venezuela. Yet, export growth has continued to decelerate since June. What data we have for October and November shows that annual export growth in dollar terms has stepped down from double digit rates to low and negative rates. This is another effect of the world slowdown.

The effect of slower export growth to Venezuela is most clearly seen in industrial output as a large part of industry's exports go there. Industrial production fell by -13.3% in November (Chart 4). But more generally, the latest data for firms' inventories and orders and other surveys of confidence are also very low. It seems then that gloomy news on the world economy has played its part in making firms cut back production, especially since September 2008.

Incorporating all this information, my staff expects that GDP will grow by roughly 1.5% on an annual basis in the last quarter. That would make GDP grow around 3.2% in 2008 as a whole. To summarize, although the slowdown in growth in the first six to nine months of 2008 was mainly caused by internal or regional factors and higher world food prices, the world financial crisis has started to affect us in an important way since September. But some of those domestic factors such as the freeze in public investment are temporary and should reverse, and so can provide a floor to our growth in 2009.

Inflation in 2008 and the start of 2009

Now let me turn to inflation. Consumer price inflation ended 2008 at 7.7%, a rate much above the target range defined for the central bank for that year of 3.5% to 4.5%, and also above the inflation at the end of 2007 which was at 5.7%. This pickup in inflation is due to rises in the prices of foods and regulated goods. In fact the inflation rate of the other items remained stable at around 4%. See Chart 5.

There is no doubt that these shocks to relative prices were transmitted to other components to some extent. We can see these second-round effects in measures of core inflation (Chart 6) and in estimates of inflation expectations, both which have risen with actual inflation (Chart 7).

But these charts also give us grounds to hope that those second-round effects will now die down, finally. For example in Chart 7 we can see that the rise in inflation expectations was less than the rise in inflation, which suggests that those surveyed did believe that these shocks would be temporary and that the central bank would not accommodate them permanently. And then also we can see that inflation expectations, even at a five year horizon, have recently started to fall back towards the target.

Moreover the fall in the international prices of inputs, energy and food items are beginning to be seen at the level of producer and even consumer prices in Colombia. Our producer price inflation rate in December fell, though mainly because of petrol. In Colombia it is likely the gasoline price will be held flat. This fall would have more dramatic as it has been in other countries if the domestic gasoline price were to have fallen. Consumer price annual inflation in January was 7.2%, down half a percentage point on December and the result of three months of consecutive falls.

Added to this, the data we have on nominal wage inflation in industry and retail sectors shows that labor costs too seem to be growing more slowly and signaling looser conditions in the labor market. Together this means less cost pressure on firms. See Chart 8.

That said, the peso has depreciated about 40% in the last six months and that has clouded this view somewhat. However the fall in world prices of imported goods have in general been even greater than the currency shift. And with domestic demand growth weak, importers should not have enough market power to push through strong increases. For these reasons, we do not expect the devaluation that we have seen up until now to push inflation far off its disinflationary path.

Of course this disinflation process has only just started and so we cannot be complacent that it will continue as hoped. In the last few years, we have been painfully reminded that our credibility is imperfect and many formal and informal forms of indexation are still in operation in Colombia. There are risks. Still, if they do not interfere, in the most likely scenario we expect that inflation will fall in line with our targets over 2009.

If this lower inflation materializes, this will bring two very important benefits for growth prospects in 2009 and 2010. First, as wage growth is not likely to fall so much, households' incomes will receive a vital boost. This will give them more scope to spend. Second, the lower inflation will give us at the central bank also scope, to carry on with a countercyclical policy stance.

The world economy

World growth will be very low in 2009. ¿What then does a world slowdown of this magnitude mean for Colombia?

The most direct effect will be in terms of less demand for our exports. In fact, our export growth already began to be affected by the slowdown and is likely to fall further. But as Colombia's exports are only just over 20% of GDP, the effect on GDP through this channel won't be as large as for other emerging market countries which are much more open.

But there are other ways in which the world slowdown will be felt in Colombia. First the price of our exports will be much lower than previous years. Second the inflows of capital that are offered to finance our development will be more restricted and offered on less favorable terms. Experience has shown us that slower export income and restricted international inflows significantly reduces our GDP growth.

On top of this, fewer remittances will arrive from our emigrants abroad. Indeed the growth rate of remittances has slowed down towards the end of 2008, and it will be a surprise if it doesn't continue to slow further.

On the other hand, it should also favor us that our capital inflows are now more in the form of Foreign Direct Investment. Much of our FDI is associated with exploiting high world prices for our commodity exports, especially for petroleum. So we should not expect FDI inflows into Colombia to be as strong in coming years as it was in the past. Yet it is also true that there are significant investments which are pre committed to ongoing projects. In fact we estimate that net FDI inflows will be about 2.5% of GDP in 2009.

The domestic financial sector

Indeed, up until now the direct impact of this financial crisis in Colombia has been moderate. Our country risk premia rose with along with heightened global risk. This pushed up the cost of the credit lines that Colombian commercial banks have with the counterparts abroad. However, Colombia has not suffered any liquidity problems in its interbank market. Nor have our domestic financial conditions been thrown into turmoil by large term and currency mismatches, as has happened recently in other emerging market countries.

When we look back and analyze how Colombia has been affected by swings in the world cycle in the past, we see that it is actually output of the nontradable sectors, such as finance and real estate, which move closely with international income flows. This puts the spotlight on our financial sector in amplifying the effect of world cycles on our domestic economy historically. Precisely because of the sturdy health of our financial sector, we have some very good reasons to expect that this slowdown will not cause a severe disruption to our economic growth this time.

First our financial regulation has improved vastly in part as a result of our last big financial crisis at the end of last century. But, second, this relative resilience is also due to some macro-prudential policies that have been carried out by the central bank and our partner institutions during the last boom phase of the world cycle.

To explain this I need to take you back to 2006. At that time, we experienced a sudden and large rise in private sector credit, no doubt as a result of strong inflows of capital and export income. Past experience has warned us that if left unchecked this would damage our financial stability. So we leant against this with an arsenal of restrictive countercyclical policy measures in 2006 and 2007.

First we raised policy interest rates by 400 basis points in between April 2006 and July 2008. In Chart 9 we can see that market interest rates on banks' liabilities and deposits followed, with some lag. In Chart 10 we can see that their real levels are close to their average since 1986 and above their average since 2001

And then also we imposed marginal reserve requirements on our domestic banks and implemented a set of capital controls to dissuade short term foreign borrowing.

Those measures are listed as follows:

- We already had limits on the net foreign currency- denominated asset position of banks and other financial institutions as a fraction of their net worth.
- We require banks and other financial institutions to have a positive net "cash" foreign currency-denominated asset position of as a fraction of their net worth. This ensures that foreign currency liquid assets exceed liquid foreign currency liabilities, thus reducing the foreign currency liquidity risk of the financial system. There is also an upper bound for the net "cash" foreign currency-denominated asset position to avoid excessive pressure on the exchange rate in episodes of rapid depreciation.
- We reactivated a deposit requirement on foreign debt and portfolio investment.
- We imposed a limit on the gross foreign exchange derivative position of Banks and other financial institutions as a fraction of their net worth. One of those was a deposit requirement against foreign currency debt; another was a limit on the cash.

In addition, the Financial Supervision authority introduced a greater provisioning requirement on consumption lending.

Now looking back, we can see that the risk of currency and maturity mismatches have been held at bay by the capital control measures. The counterparty risk in the foreign exchange market has receded as a result of the limit on the gross foreign exchange derivative positions.

As a consequence of these policies, the adjustment in our domestic credit markets to rapidly changing economic conditions has been smooth and orderly. The total stock of lending of the financial system is now growing at 17%, compared to 24 % a year ago. Lending for consumption especially has slowed down from the dangerous rates of 50% in 2007 to be closer to 10% now (Chart 11).

Towards the end of 2008, the growth in lending to firms rose even though the spread on lending interest rates was also climbing up. This greater demand for credit could have been from firms planning ahead for tighter conditions in 2009. Just recently we have seen lending to firms decelerate again although by not as much as lending to households. Corporate lending is now at about 19%. Mortgage lending growth has also slowed down but more gently and is now at about 15%. All in all, lending growth is slowing down towards nominal GDP growth but at a gradual pace.

Credit growth should be expected to slow down with weakening economic activity. Clearly there has been a restriction in the flow of credit to riskier households and smaller firms. But even despite a dramatic worsening of external conditions, this adjustment in domestic credit conditions has been smooth and orderly.

In this sense, the combined measures taken by the Banco de la República and the Financial Supervision Authority have converted what would have been an unsustainable dynamic into something much healthier. We have avoided an excess build up of debt of firms and households and so have kept our financial intermediaries solvent.

In conclusion, the threat of excessive credit of the last three years has been contained by a set of macro-prudential policies. Our financial sector is now well capitalized. It is liquid.

We cannot underestimate the benefit of healthy financial balance sheets as we enter the down phase of the world cycle. For one thing, our banks will not have to cut credit to the private sector sharply, because they will not have as many bad investments to recuperate. This should help minimize the contraction in output, expenditure and employment. And then also, we can expect that our monetary policy loosening in the down phase of the cycle will be transmitted onto the real economy. In other countries, this mechanism has jammed.

Forecasts for 2009

In summary, the gloomy world outlook will mean lower demand for our exports, worse terms of trade, fewer remittances and more expensive foreign borrowing. Nevertheless we still expect to be able to sustain our external liabilities and we certainly do not foresee any sudden shutdown in domestic credit.

In this context, we expect that GDP growth would be less than 2009, but we will still grow, probably in a range from 1 to 3%, compared to about 3.2% for 2008. We expect inflation to fall to within our target of 4.5 to 5.5%.

As consumers have already taken a great step towards rebalancing their finances last year, domestic demand will have to adjust by less than GDP. Therefore we would expect our current deficit to open up slightly. Consistent with we expect that the current account deficit in nominal terms will be in between 3.7 and 4.3% of GDP in 2009, slightly greater than our estimate of 3% in 2008.

We do not expect any very large depreciation, and so we expect that the lower prices of especially food and energy in world markets will be passed on onto our domestic prices. Our central case is also for some moderation of price rises in regulated items. This, combined with the cooling in domestic demand, will mean that inflation converges towards our target range for the end of 2009, which is 4.5 to 5.5%.

These forecasts are based on the following assumptions about 2009:

1. Growth in the United States between -2.5 and -2%;
2. Venezuelan growth around 0%;
3. The West Texas Intermediate oil price between US$ 35 and US$ 48 per barrel;
4. A strong recovery in public investment;
5. Government consumption growing between 2 and 3%;
6. That the weak data on recent indicators in industrial output, retail sales and unemployment all show up in official data for the end of 2008 and the start of 2009;
7. But also that the large depreciation will help limit the fall in exports;
8. And that the past and any future monetary policy actions feed through onto the real economy.

Conclusions

Let me now bring this together to explain what I expect for monetary policy in the next year.

A large rise in the relative prices of food, regulated goods and raw material inputs were responsible for pushing up inflation in 2008. As a consequence, we failed to meet our inflation target for the second year in a row. These relative price shocks held down real disposable income, and so also contributed to a marked slowdown in consumption and GDP growth.

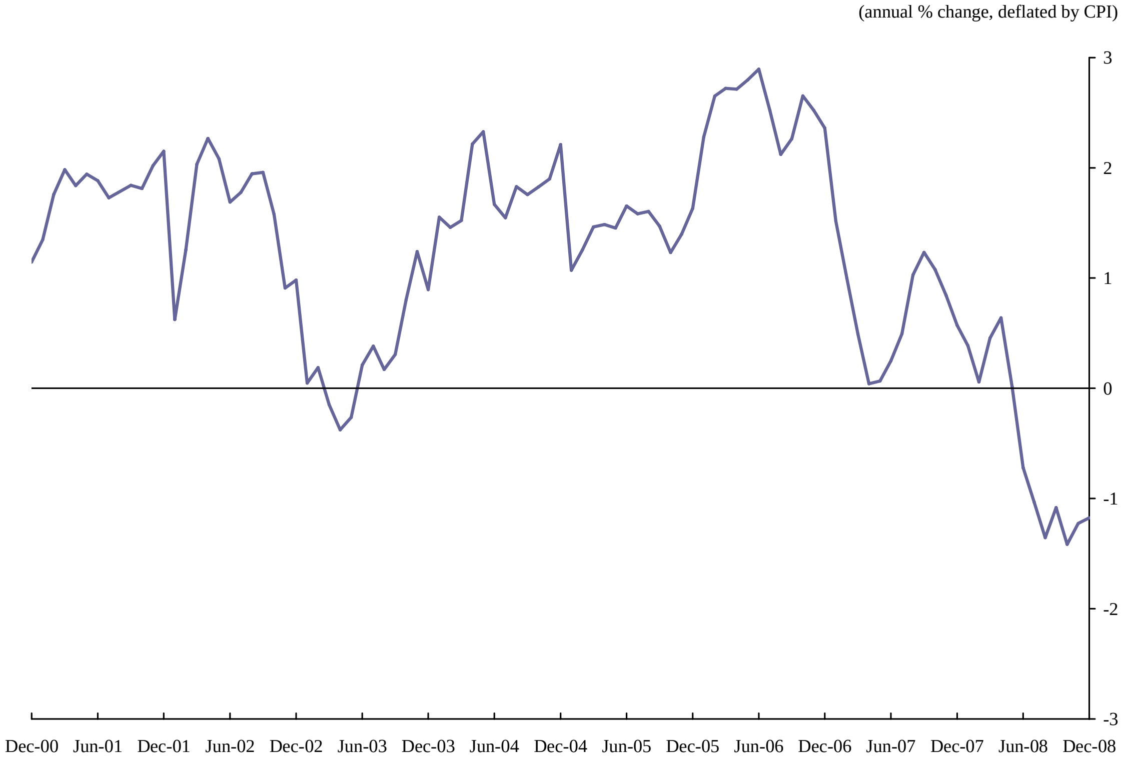
The international financial crisis started to affect our economy in an important way in 2008. We expect that we will feel its full effect over 2009. We would need some scope to offset any excessive adverse effect on our growth. Added to that we have to acknowledge that our credibility is imperfect and that many important prices in Colombia are indexed to past inflation.

In this context, any return of inflation to lower levels would have to be gradual. So the Board of the Banco de la República chose a target range for inflation at the end of 2009 of 4.5 to 5.5%. But to affirm our long-term commitment to stabilize inflation at low levels, we also announced that the mid point of the target range for 2010 will be 4%.

We cannot allow inflation to settle at levels above this target path. One important reason is that otherwise our longer term market interest rates would rise and squeeze the net income of domestic borrowers. Higher inflation would amplify the effects of the world slowdown on our growth.

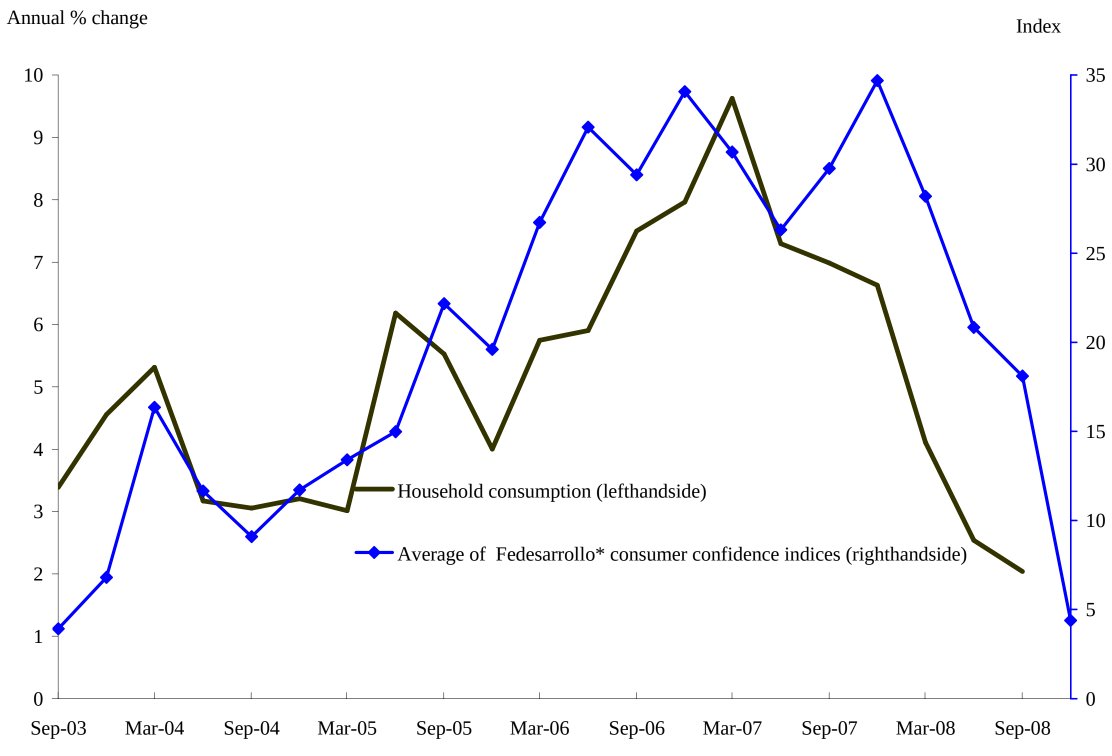
In this sense the extent to which monetary policy is able to adopt a countercyclical stance depends on the second-round effects of these relative price shocks dying away. If prices correctly reflect the much weaker market conditions, instead of simply indexing on past inflation, then inflation will fall back and monetary policy actions can support growth. This will be the mostly likely scenario.

Chart 1. Real minimum wage



Source: DANE and calculations by Banco de la República.

Chart 2. Household consumption and Fedesarrollo household consumption's survey



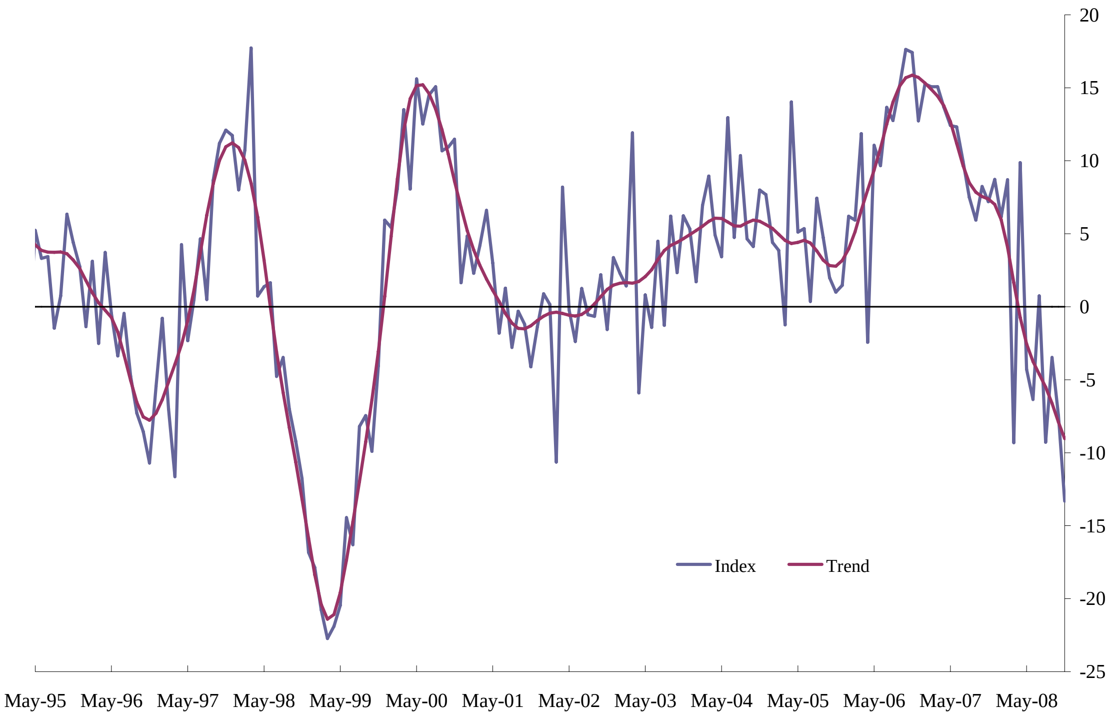
Source: Fedesarrollo. Calculation by Banco de la República* Average of ICC, IEC e ICE; Consumer Confidence Index, Expectativas de Consumo and Condiciones Económicas respectively.

Table 1. Imports

	January-November			Annual growth (%)		% Total	
	2006	**2007**	**2008**	**2007**	**2008**	**2007**	**2008**
Consumption goods	4,281	6,225	6,929	29.1	11.3	20.7	18.9
Intermediate goods	10,553	13,014	16,511	23.3	26.9	43.3	45.1
Capital goods	8,425	10,803	13,139	28.2	21.6	35.9	35.9
Unclassified goods	16	21	24	30.3	15.8	0.1	0.1
Total	**23,815**	**30,063**	**36,603**	**26.2**	**21.8**	**100.0**	**100.0**
Total without military equipment	**23,681**	**29,856**	**36,185**	**26.1**	**21.2**		

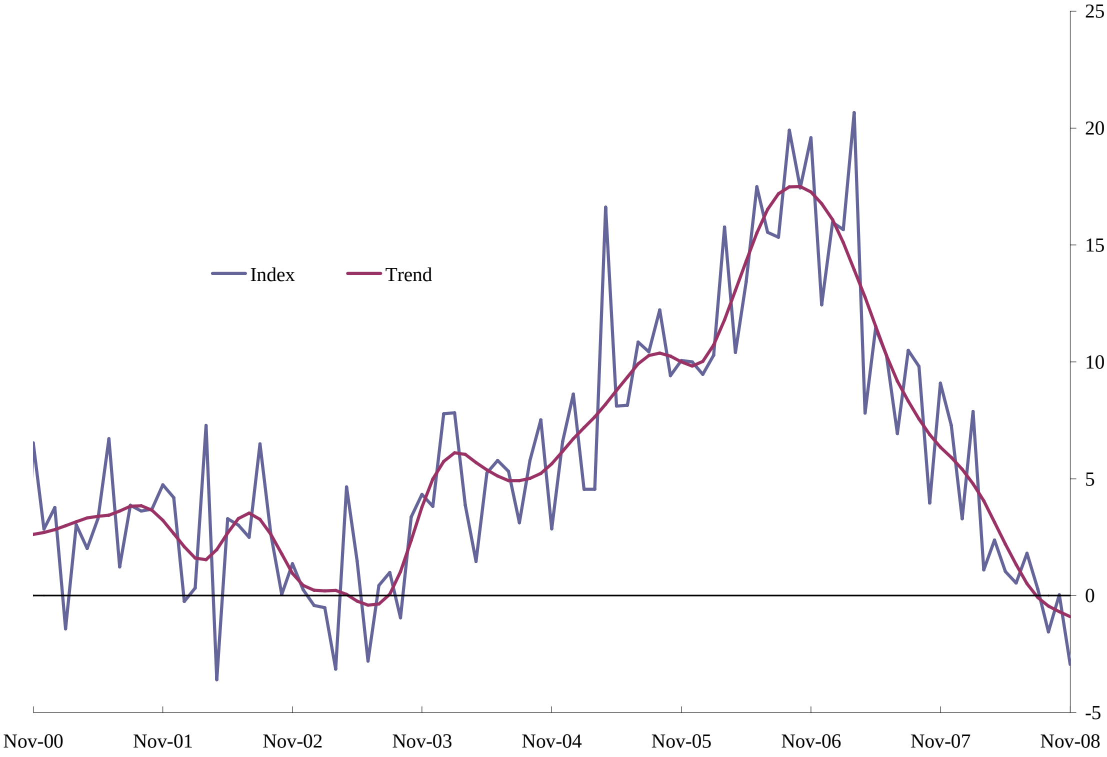
Source: DANE.

Chart 3. Index of industrial production (without coffee threshing)



Source: DANE and calculations by Banco de la República.

Chart 4. Retail trade without fuel



Source: DANE and calculations by Banco de la República.

Table 2. Real annual growth GDP by Production

	2006	2007	2008		
			I Quar.	II Quar.	III Quar.
Agriculture, forestry, fishing and hunting.	3.9	3.9	3.8	4.4	1.2
Mining	3.2	2.9	4.6	8.3	10.1
Manufacturing industry	6.8	9.5	2.0	1.3	-2.4
Electricity, gas and water.	3.1	3.7	0.7	1.7	1.4
Construction	13.5	11.5	1.2	5.0	16.8
Buildings	11.8	1.1	25.6	27.6	26.3
Civil works	14.8	19.1	-14.2	-7.9	10.4
Distribution, hotels and catering.	8.7	8.7	2.5	2.7	0.0
Transport, storage and communication.	9.2	11.0	9.3	4.9	3.4
Financial intermediation, real estate, business and rental services	6.7	7.3	7.5	4.9	6.5
Social, communal and personal services.	4.7	4.7	4.0	2.7	2.6
Subtotal added value.	6.5	7.2	4.3	3.6	3.2
Tax minus subsidies	11.6	11.5	6.9	5.6	2.8
GDP	**6.9**	**7.5**	**4.5**	**3.8**	**3.1**

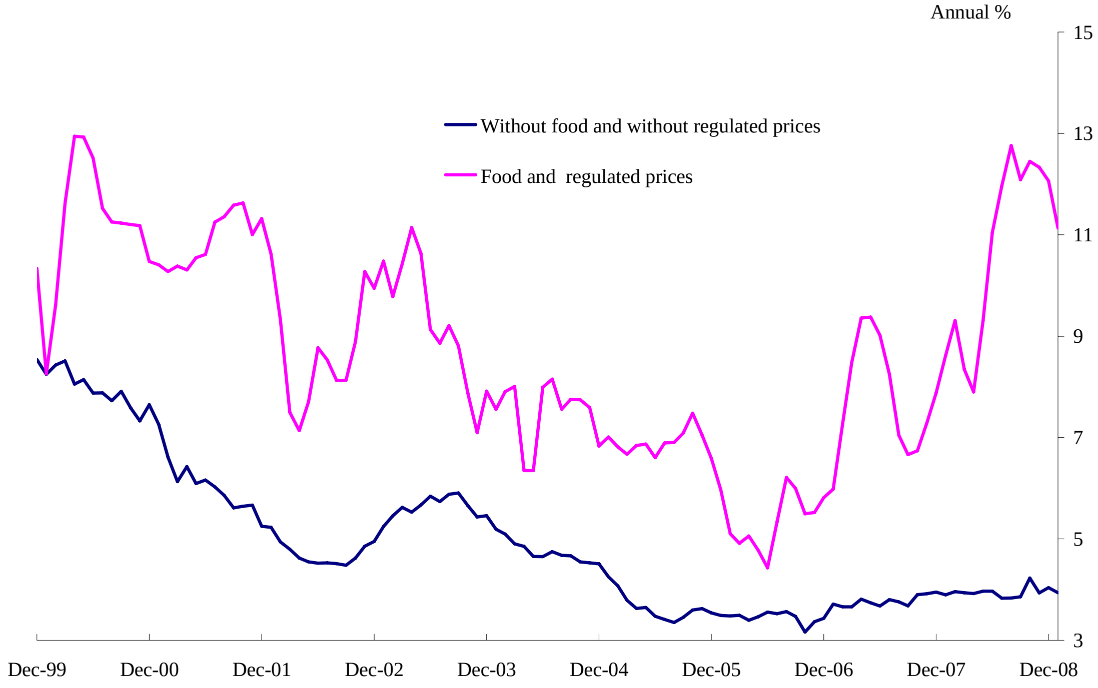
Source: DANE and calculations by Banco de la República.

Table 3. Real annual growth GDP by expenditure

	2006	2007	mar-08	jun-08	sep-08
Final consumption	6.2	6.9	3.7	2.3	2.0
Household consumption	6.8	7.6	4.1	2.5	2.0
Government consumption	4.2	4.5	2.1	1.5	1.9
Gross capital formation	19.1	13.7	9.1	9.3	12.0
Final domestic demand	8.9	8.5	4.9	4.0	4.4
Exports total	8.0	11.4	13.1	9.6	1.4
Imports total	16.2	13.9	11.7	8.2	7.0
GDP	6.9	7.5	4.5	3.8	3.1

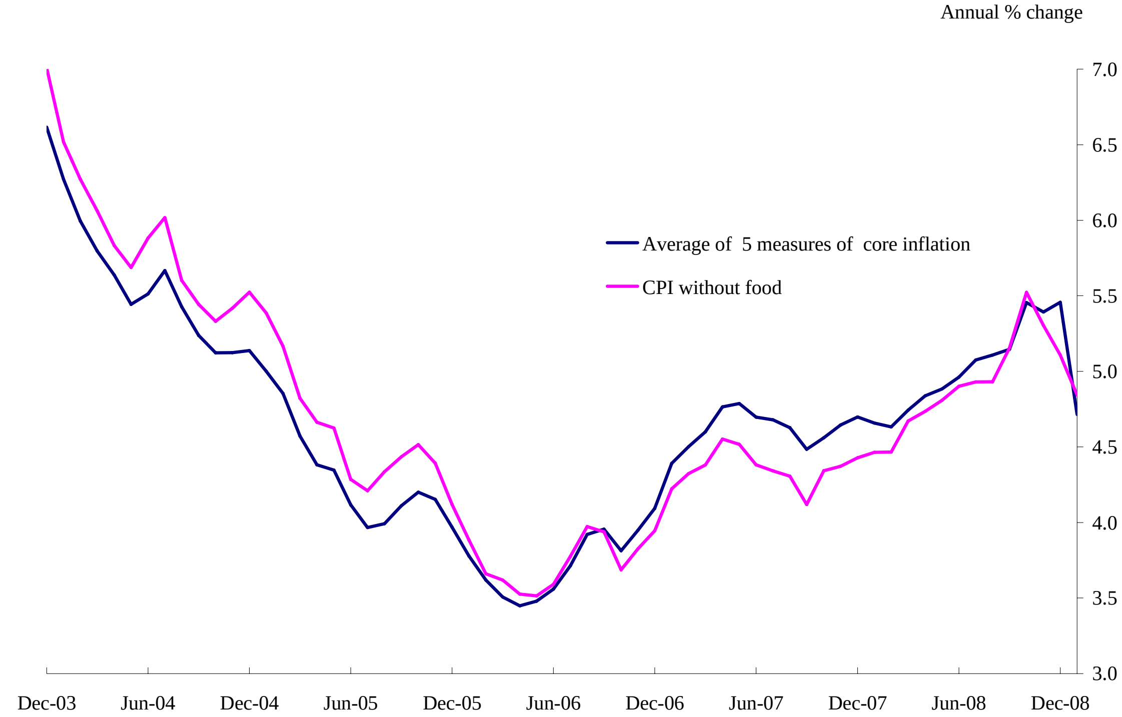
Source: DANE and calculations by Banco de la República.

Chart 5. Food and regulated prices versus all other items in the CPI



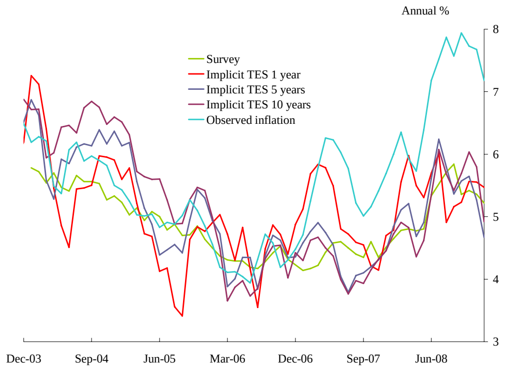
Source: DANE and calculations by Banco de la República.

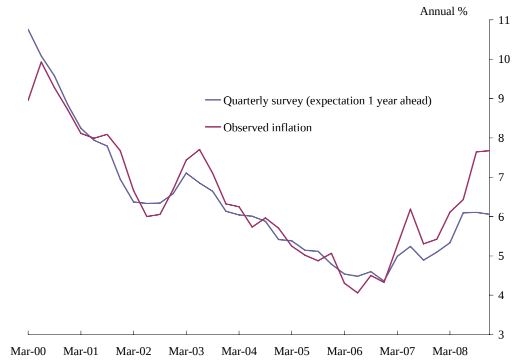
Chart 6. Core inflation



Source: DANE and calculations by Banco de la República.

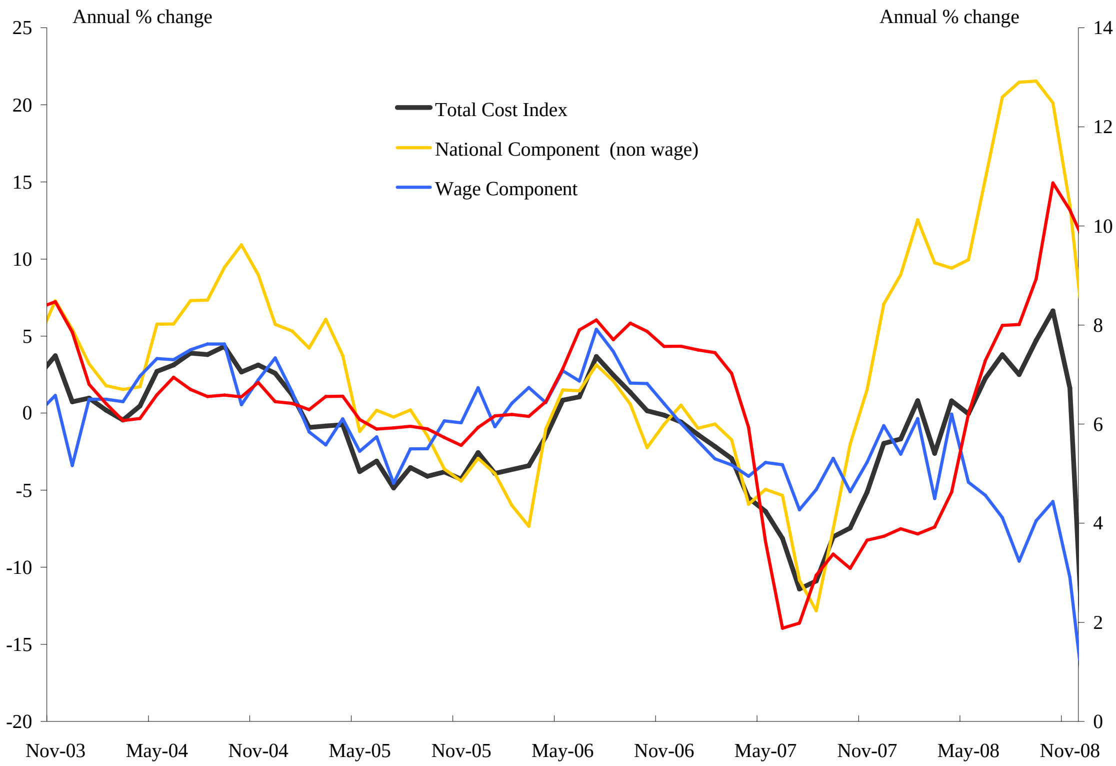
Chart 7. Inflation expectations





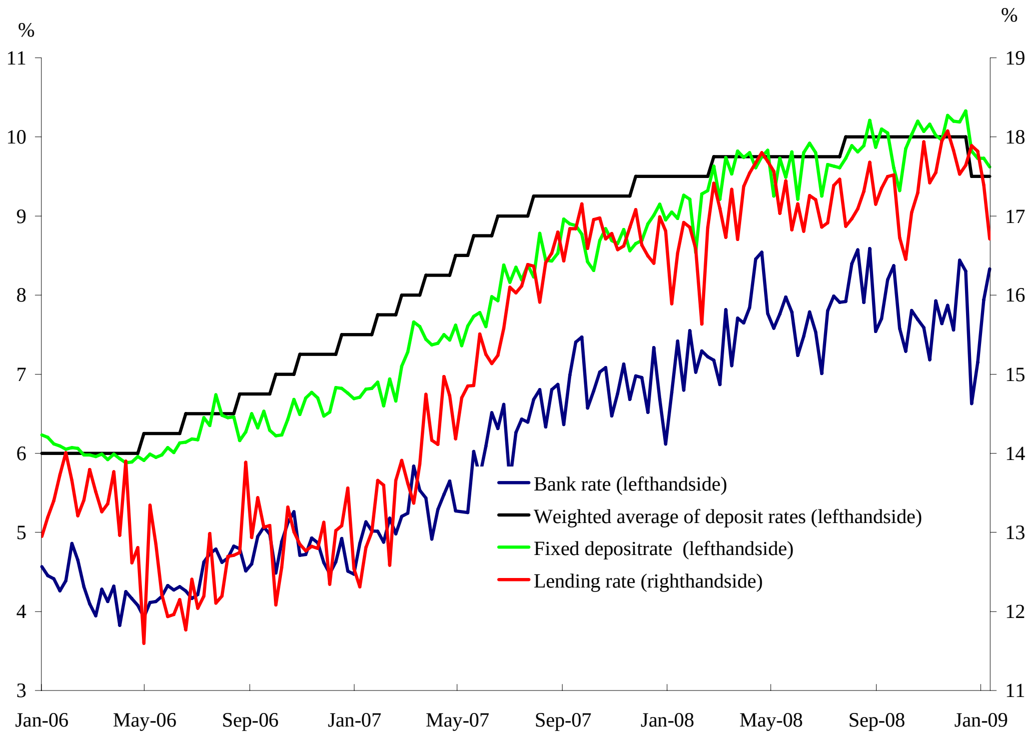
Source: Banco de la República.

Chart 8. Cost index based on the Social Accounting Matrix



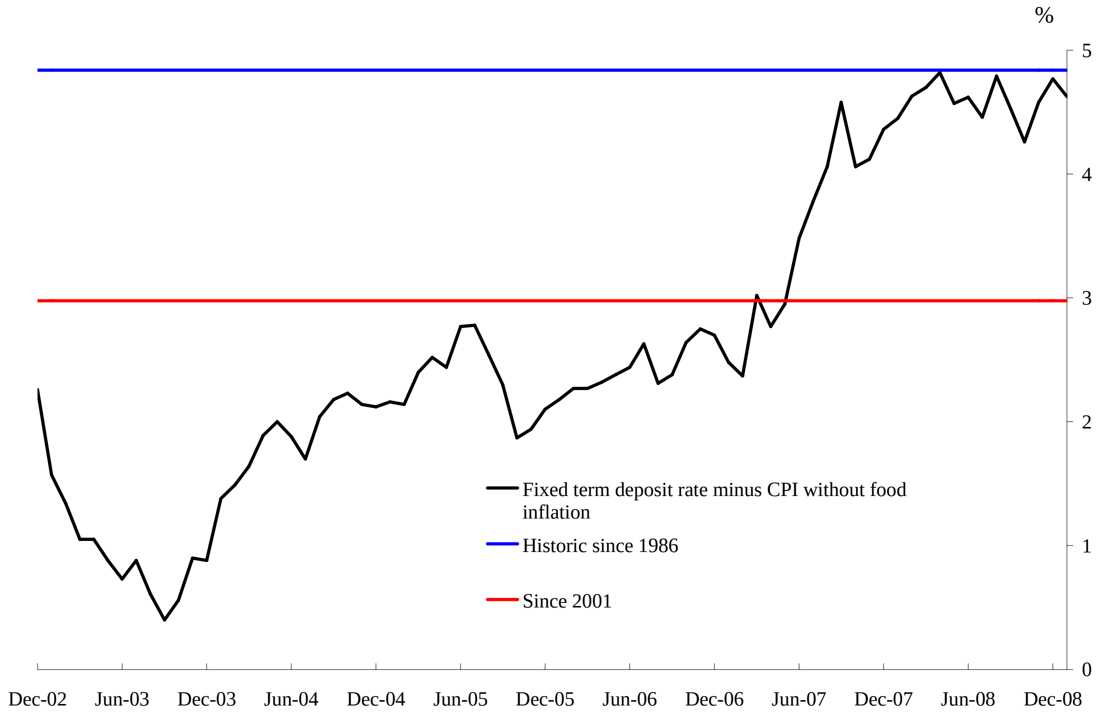
Source: DANE and calculations by Banco de la República.

Chart 9. Nominal interest rates



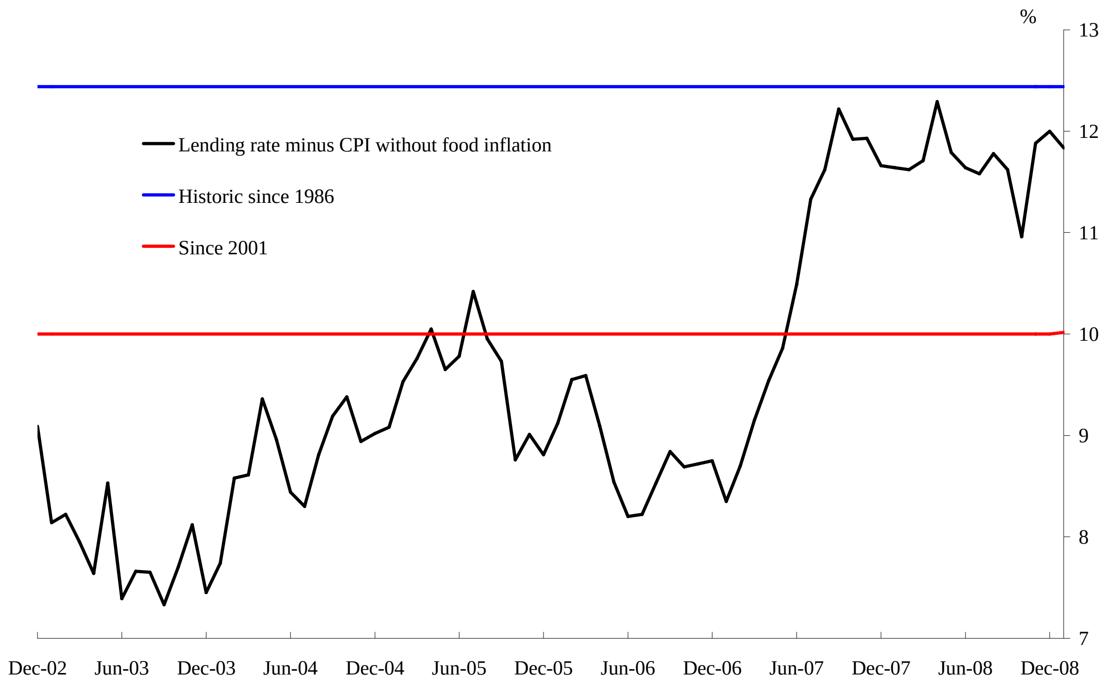
Source: Banco de la República and Superintendencia Financiera de Colombia* The fixed term deposit rate is brought forward one week, as so is the effective rate for the week ahead, and then can be compared to the weighted average deposit rate.

Chart 10a. Real interest rates



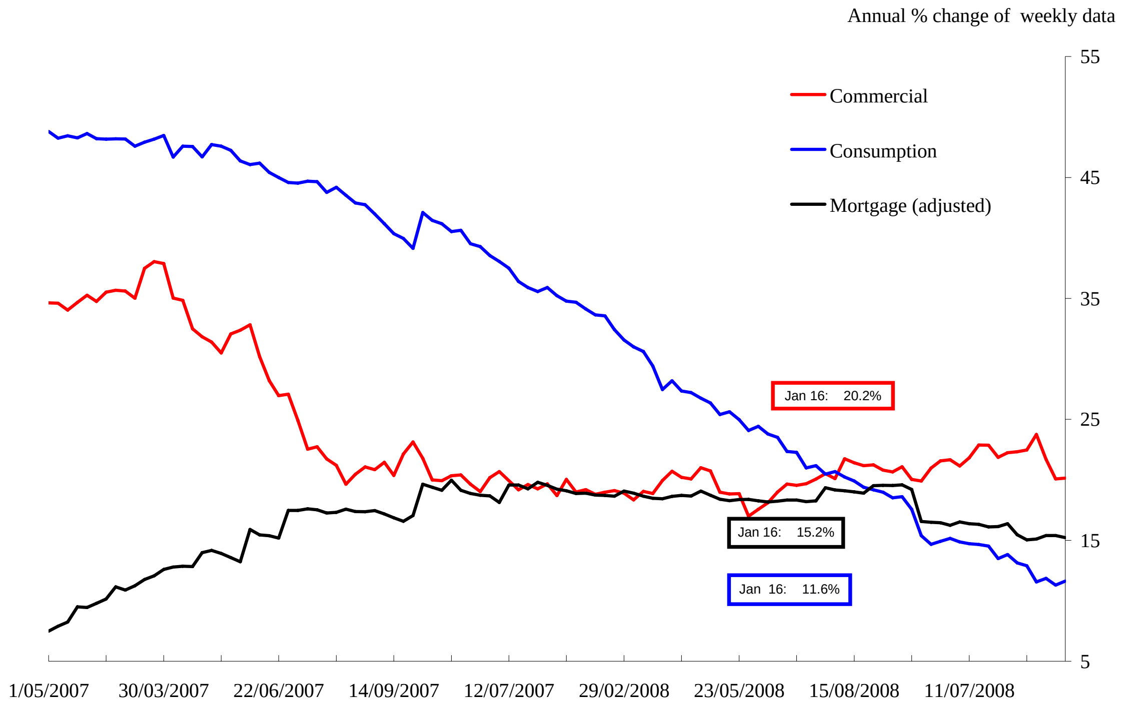
Source: Banco de la República and Superintendencia Financiera de Colombia

Chart 10b. Real interest rates



Source: Banco de la República and Superintendencia Financiera de Colombia

Chart 11. Gross portfolio in pesos by category of credit



Source: Format 281 of Superintendencia Financiera de Colombia.
Does not include FEN (Financiera Energética Nacional).