

POLICY CHALLENGES FACING CENTRAL BANKERS IN LATIN AMERICA

Emerging Markets – Spring Lecture Series

Sunday, April 6th 2008

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I. Introduction

These are difficult times for central banks. After four consecutive years of strong world growth, it is now obvious there will be a dramatic slowdown in the United States economy this year. It also is a fact that the financial problems sparked by the so-called sub-prime crisis in the United States have spilled over into some of the major European economies. In addition, quite a few countries have seen a sharp increase in inflation and inflationary expectations. Can the Latin American economies, particularly Colombia, deal successfully with the challenges implied by a severe decline in the growth of some of the world's major economies, coupled with rising inflation?

My answer to this question is yes, at least for some of the region's leading economies, including Colombia. Of course, there is always the risk that problems associated with the international financial crisis will have more of a negative impact than those explicitly or implicitly assumed in these remarks, or that the recent price shocks we have seen will intensify. However, given the figures now at hand, I believe it is reasonable to assume that Latin America, as a whole, will see satisfactory growth this year and that the central banks have leeway to prevent relative price shocks from becoming a generalized increase in inflation.

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II. Economic Growth

Let us begin by examining how the Colombian economy has grown. At the Central Bank of Colombia, we have developed a number of GDP growth estimates that consider the impact monetary-policy decisions have had on the increase in spending, assuming 0.5% - 0.8% economic growth in the United States during 2008 and a reduction in trade with Venezuela. The results show the Colombian economy will expand by about 5% this year. The average forecast by local and international analysts is 5.3% growth, which is quite similar to our estimate. Five percent (5%) is less than the 7.5% increase we saw in 2007, but is a historically high figure for Colombia. Furthermore, the country's experience during the last two years, with economic growth near 7%, on average, suggests that, if growth were to continue at that rate, it eventually would be unsustainable. For example, inflation began to rise and the current account deficit increased last year by more than one percentage point of GDP.

There are several reasons why it is possible to forecast around 5% grow for the Colombian economy this year. Allow me to describe some of them briefly:

- The baseline is an economy with high growth rates, fueled largely by a strong increase in local demand. The growth in demand is generalized and includes household and companies, as well as the private and public sectors (more demand in the public sector is related to investment).
- With around 0.5% -0.8% economic growth in the United States, it is reasonable to assume that terms of trade will remain high. Even a moderate drop in international export prices would not affect growth significantly.
- So far, the extent of consumer and producer confidence has been historically high.
- In the last three year, particularly during 2007, foreign direct investment was a driving force of growth. So far this year, the inflow of capital for that item is almost twice what it was last year.
- Exports to Venezuela continue expand at high rates, offsetting the reduction in exports to the United States. Prospects for economic growth in Venezuela

during 2008 remain positive, even with a moderate drop in international oil prices.

- Having risen sharply in the early years of the present decade, remittances from Colombians working outside the country are a source of revenue characterized by a certain degree of stability.
- In general we are less vulnerable to any sudden depreciation of our currencies. Broadly speaking, Latin American countries have smaller shares of foreign currency debt, a greater part of external debt in more stable foreign direct investment and more international reserves than previous crises.

Naturally, what remains to be analyzed is the potential contagious impact the turbulence on international financial markets could have on Colombia. In the nineties, for example, we witnessed the devastating effects on growth and stability in the financial system caused by the sudden flight of capital and the increased cost of external financing. But, here again, we have cause to be optimistic. Let us briefly consider why.

- The baseline for any increase in the cost of external financing is a historically low debt spread. Even if that spread were to double in 2008, it would be similar to what it was in 2003, when the country experienced a considerable build-up in economic growth.
- The Colombian financial system is better prepared to deal with a negative external shock than it was in the past. The country has made great strides towards financial supervision and regulation. Bad debt ratios are historically low, and Colombian banks are not exposed to sub-prime risk. The availability and quality of information for financial institutions has improved. The branches of foreign banks with serious problems related to the sub-prime market have a minority stake in the sector.
- The negative external shocks, once inflation and inflationary expectations are back on target, allow for the possibility of a counter-cyclical monetary policy. I will return to this point later.

Some of the factors that permit us to be moderately optimistic about the outlook for the Colombian economy in 2008 are applicable not only to Colombia. By in large, they are valid for the region as a whole. Naturally, there are differences, but an educated guess is that Latin America, for reasons such as the foregoing, will report satisfactory economic growth in 2008. At this point, it is difficult to say what will happen in 2009 if, for example, the developed economies continue to experience serious problems.

III. Inflation

The main concern in Colombia during the last 18 months, from a macroeconomic standpoint, has been the rise in consumer inflation. As in many other countries, the increase in inflation has been associated mostly with high fuel and food prices.

Our view, at the Central Bank of Colombia, has been that transitory external shocks to food and fuel prices need not affect inflation in the mid-term and the long run provided inflationary expectations do not deviate from the targets and cost and demand pressures do not convert what should be one-off rises in the level of prices into a sustained increase in inflation.

Unfortunately, at least in Colombia during 2006 and 2007, the risks of the latter happening were considerable. In late 2006, the economy began to grow beyond its potential output. Moreover, inflation has been running above target since early 2007, and the various measurements of core inflation show significant increases. Under these circumstances, there is substantial risk that additional price shocks could have a negative impact on inflationary expectations. In fact, as of the second half of 2007, inflationary expectations derived from the government bond market, as well as those reflected in a number of Central Bank surveys of the business community and analysts, show a great deal of upward movement.

In view of this situation, the priority is on generating balanced conditions in supply and demand that are consistent with keeping inflation on target and achieving sustained growth in output. However, doing so implies lowering the increase in demand and

relieving capacity pressures in the economy. Consequently, during the period since April 2006, the Central Bank's Board of Directors raised the policy rate from 6% to 9.75%, and imposed an average marginal reserve requirement of 23% on bank deposits.

Many Latin American countries have witnessed higher inflation in recent months. A perfunctory breakdown of the build-up in inflation in all of those countries would suggest that its origins can be traced to exogenous and transitory price increases for food and fuel. However, surplus demand and higher inflationary expectations could be behind the increase in inflation.

An incorrect diagnosis of the recent increase in inflation could lead to a sustained rise in inflation. This has costs per se and requires dealing with the cost of disinflation, in the future, in an atmosphere where the monetary authority's credibility has suffered. It also can make the region's economy vulnerable to negative outside events. For example, high inflation and inflationary expectations allow for less leeway to develop a counter-cyclical monetary policy when the economy enters the low part of the economic cycle.

Conclusion

In summary, these current times are particularly difficult for monetary policy in Colombia and in general Latin America because we face large risks in opposite directions. On one hand our domestic demand has been going strongly, and if we leave that unchecked, that could lead to a sustained and costly rise in inflation. On the other hand the United States and other parts of the developed world are slowing down because of the international financial crisis. One option for domestic monetary policy is not to raise domestic interest rates against inflation, or even lower them, and assume that the slowdown in world growth will do the work of bringing down inflation. Another possible strategy is to deal with excess demand and inflation now and therefore gain more leeway to tackle any generalized slowdown that we might be facing later on.

We have been trying to get the best balance between these two options. We are also aware that whatever we decide now may have to be revised as this crisis unfolds. My aim here was only to argue that our economies are better placed to manage these kinds of mixed risks than they were in the past. The new monetary policy frameworks and

supporting institutions that many of us have built were deliberately designed to give us the discretion to handle scenarios like this without losing focus on the primary responsibilities of a central bank.