10 years of Flexible Inflation Targeting in Colombia

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Outline

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I. Main elements of our IT

A. Conventional

Legal mandate

"The primary goal of monetary policy is price stability, in coordination with the objectives of general economic policy"

≈

Flexible Inflation Targeting (Svensson, 1999)

Objectives

- Stabilize inflation around the inflation target
- Stabilize resource utilization around a normal level

$\Rightarrow$

$$Loss = \sum_k \beta^k \left[(\pi_{t+k} - \pi^*)^2 + \alpha_y (y_{t+k} - y^*)^2 \right]$$

subject to the structure of the economy

- Target: 2% ≤ π^* ≤ 4%
- Lags of monetary policy $\Rightarrow$ Forecast of inflation and output
- Forecasts are conditional on our view of
  - State of the economy
  - Transmission mechanism
  - Forecast of exogenous variables

- Instrument: overnight repo rate, *r*.
- Rule: adjust *r* to reach inflation target and stabilize output (periods ahead)
- Explanation of policy measures and intentions in order to guide inflation expectations and economic activity to normal levels.
- Exchange rate flexibility as shock absorber. It also helps to minimize prociclicality of credit and reduce incentives to excessive external debt and currency mismatches.

B. Unconventional

What did we learn in Colombia from the real and financial crisis of the late 1990s?

- Credit growth and asset prices (i.e. real estate) may have negative effects on inflation and output growth
- Large currency mismatches compromise financial stability in the event of a correction of the exchange rate

- As the price of an asset, exchange rates are very volatile. And attempts to reduce this volatility substantially could increase volatility in π and y

- When credit or asset price dynamics take hold, additional instruments should be used as supplement to the setting of the monetary policy instrument (r)

What did we do?

- Enhanced interpretation of policy goals: long horizons for objectives on π and y imply the need to act preemptively to avoid large financial and macroeconomic imbalances

- Enhanced set of policy instruments
  - FX interventions
  - Reserve requirements
  - Capital controls
  - FX macroprudential regulation

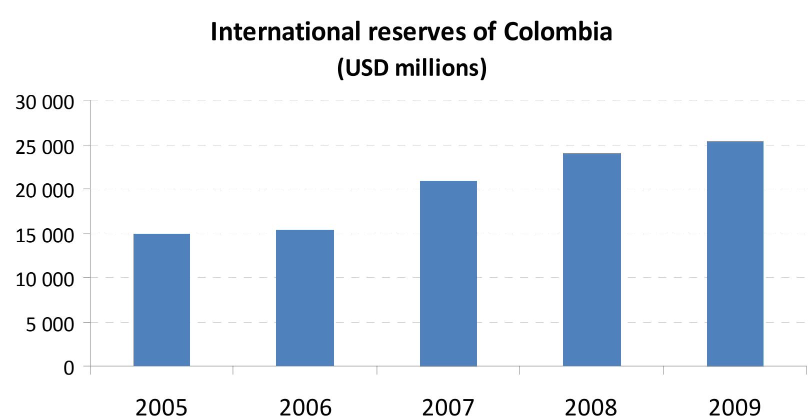
FX interventions

(without any exchange rate target)

- Goals:
  - Buildup of IRs as a buffer against external shocks and to minimize contagious risk.
  - Mitigation of exchange rate misalignments (in an asset price sense)

- Problem:
  - May conflict with other tools
  - Discretionary vs. Systematic purchases

Accumulation of international reserves

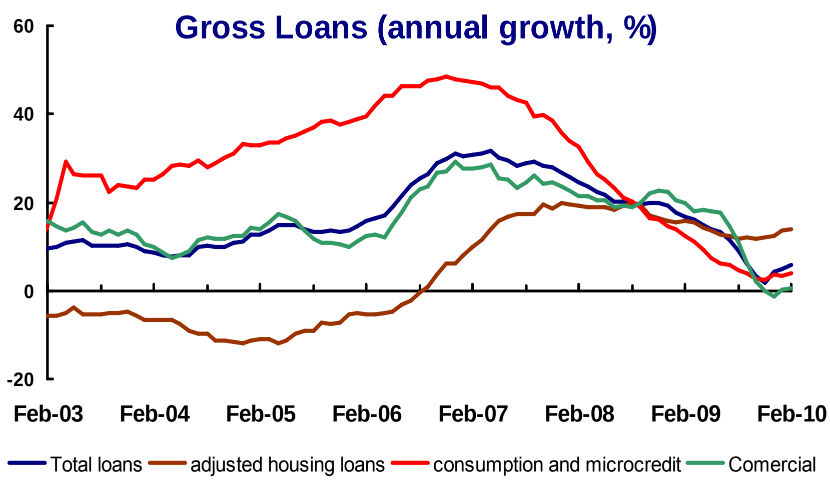


Source: Banco de la República.

Marginal reserve requirements

- Goals:
  - Reduce excessive leverage and credit growth
  - Strengthen the transmission of overnight repo rate movements
- Problem:
  - Effectiveness depends on the degree of substitutability of bank funding (deposits vs. repos)
  - Too blunt an instrument to fine tune macroeconomic performance

They helped to contain credit expansion in 2006-7, without collapse in 2008-09



* Local Currency

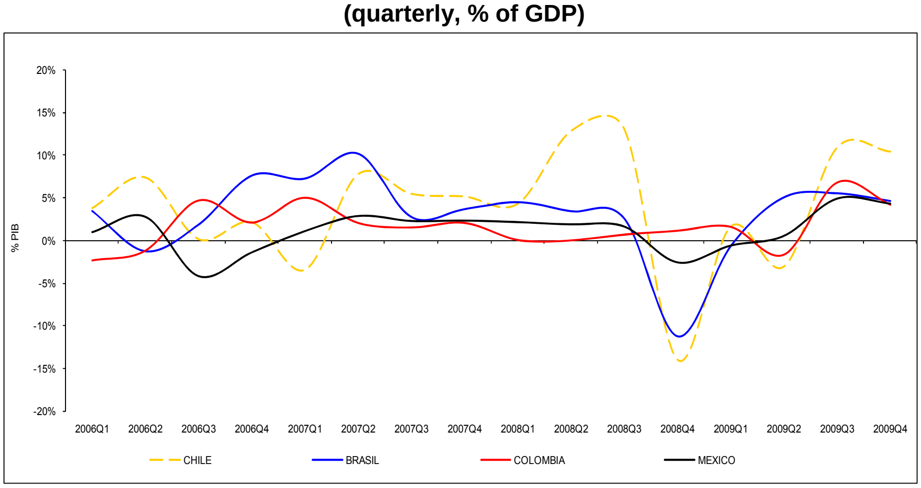
Source: Banco de la República.

Capital controls

- Goals:
  - To partially isolate monetary policy from external forces.
  - Mitigate currency and term mismatches
- Tools: deposit requirements on foreign loans (discriminate against short term external borrowing)
- Problems:
  - Inefficient allocation of capital and resources
  - May adversely affect small and/or financially constrained firms (Forbes, 2005)
- However, temporary in nature

They smoothed portfolio and debt flows

Foreign Investment Portfolio + Debt Flows in Latin America (quarterly, % of GDP)



Source: Banco de la República.

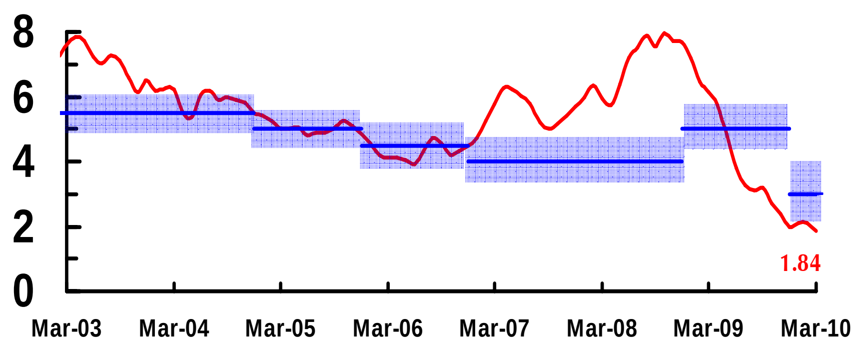
FX macro-prudential regulation

- Goals:
  - Mitigate currency and term mismatches
  - Enhance financial stability
  - Provide the conditions for FX flexibility
- Tools:
  - Non-negative net FX cash position of local banks
  - Limits to gross FX derivative positions as a % of net worth of banks
  - Restriction on the currency and FX term mismatches in bank's balance sheets
- Problems:
  - Inefficient allocation of capital and resources
  - May affect adversely small and/or financially constrained firms (Forbes, 2005)
  - May hamper financial deepening and development

II. Outcomes

1. Price stability has been achieved

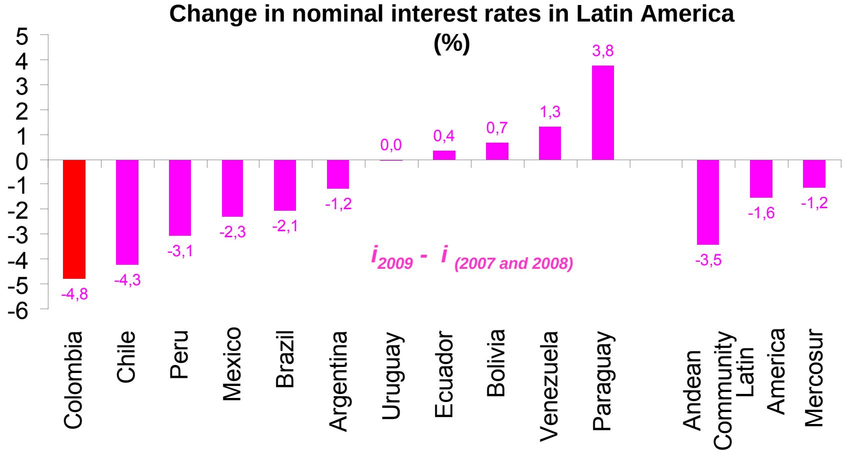
Annual Inflation and target range (%)



Source: DANE and Banco de la República.

2. Monetary policy has contributed to smooth output fluctuations

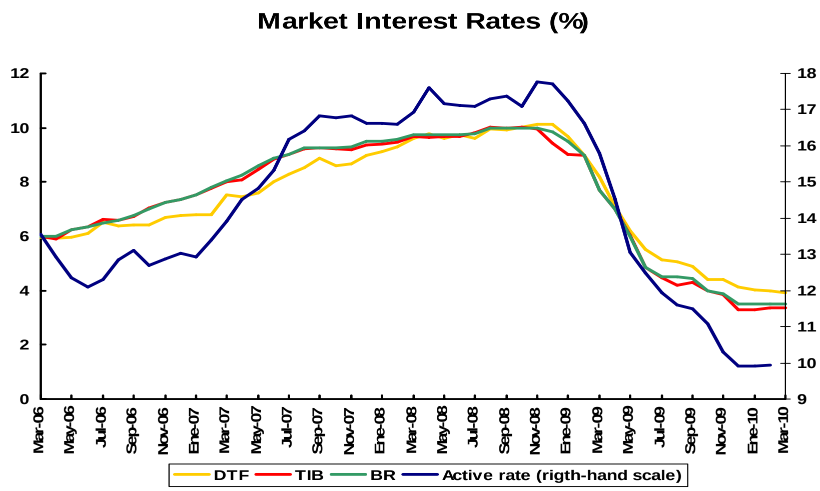
Change in nominal interest rates in Latin America (%)



Colombia provided one of the largest monetary stimulus in the region.

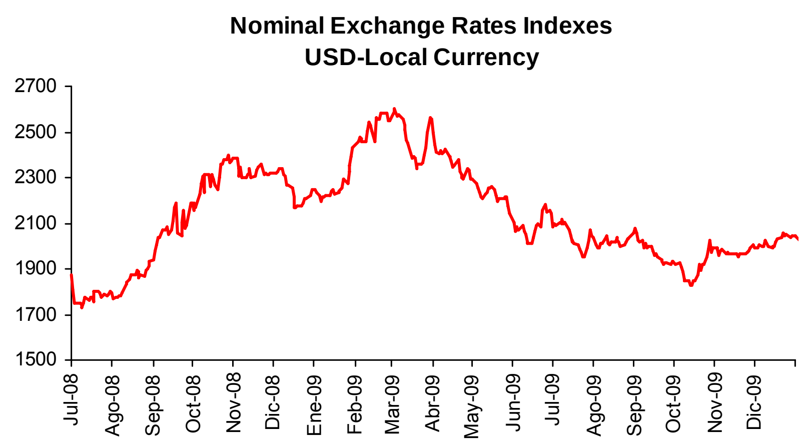
Source: Lat.Am. Consensus Forecast, March 2010

Interest rate policy transmitted rapidly to market rates



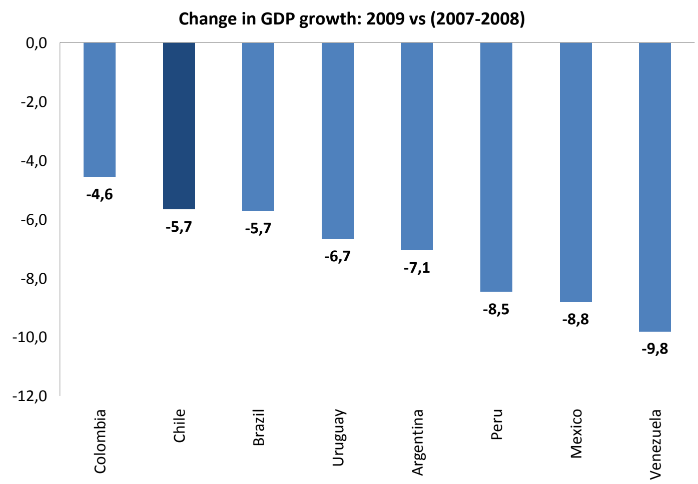
Source: Banco de la República.

The flexible exchange rate was an important shock absorber



With no FX intervention since September 08 and 2009

As a result, the Colombian economy decelerated less than its peers



Source: Lat.Am. Consensus Forecast, Marzo de 2010

III. Some lessons and challenges

- Discipline of focus is needed to achieve and maintain low and stable inflation.
- IT is a flexible framework that enables the economy to respond to a wide range of shocks. It should be considered as a continuously evolving framework.
- Even if monetary policy achieves price stability, it cannot, by itself, guarantee macroeconomic stability.

- Financial factors affect the transmission mechanism and should be considered as indicators of future inflation and resource utilization (Svensson, 2010)
- Instruments other than interest rates should be used to avoid large financial and macroeconomic imbalances. Longer forecast horizons than the traditional are needed.

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