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"Economic Acceleration and Structural Reforms in Colombia"

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Good morning. It is my pleasure to participate in this talk organized by ANIF and FEDESARROLLO. I thank the Directors, Sergio Clavijo and Leonardo Villar, for the invitation they have extended. I will share with you some words on the the recent decisions of monetary and exchange-rate policies of the Board of Directors at the Banco de la República.

More specifically, my comments will explain why the interest rate was set at 4% last month, a lower rate than was expected six months ago. Likewise, I will refer to the Board's announcements on the accumulation of international reserves, which at the moment demonstrate the Bank's commitment to buying at least $3.55 billion USD during the first five months of the current year.

Annual GDP growth and prices are lower than expected

At the end of 2011, the Colombian economy was characterized by a strong growth in aggregate expenditure and external debt, as well as a continued increase in the housing prices. On one hand, there was doubt over the sustainability of this dynamic despite the fact that the Board of Directors of the Bank raised the interest rate from 3% in February of 2011, to 4.75% in November of the same year. On the other hand, the global economic growth in 2012 was projected to be lower than it had been in 2011. The worry over the sustainability of the growth of Colombian expenditures and external debt, in a context of high doubt regarding income from commodity exports and foreign investment, led to the Bank's decision of increasing the interest rate by 25 basic points, so that in February of 2012 it reached 5.25%.

Keeping in mind the increase in the interest rate and the weakening of the global economy, Banco de la República projected a deceleration of GDP growth, which had been at 5.9% in 2011, to 5% in 2012. However, the deceleration of GDP growth during the second semester of 2012 was greater than expected. It is currently being estimated that Colombia grew 3.6% in 2012, with a margin of error of +/-0.3 percentage points.

Meanwhile, at the end of 2011 consumer inflation was 3.7%, a higher rate than the long term target of 3%. Core inflation showed a slight increase in the second half of 2011, and inflation expectations, as approximated by various measures, surpassed 3%. Banco de la República projected inflation to be at 3.2% by the end of 2012. However, inflation measured was at 2.4%, a rate much lower than expected. By January of 2013, it was measured at a steady rate of 2%, the inferior limit of the inflation target defined by the Board of Directors of the Bank. Thus, expectations for inflation in the short and medium terms were set below 3%.

In other words, all information on economic activity of the second semester of 2012 and January of 2013, specially after the month of September, indicates that the Colombian economy has had a stronger deceleration than previously projected. With the new available information it is expected that GDP and employment will grow at lower rates than predicted last trimester. At the same time, inflationary pressures are very low. Keeping in mind the weakening of economic activity and the decrease in inflationary pressures, Banco de la República expects for GDP to be below the economy's productive capacity, and for inflation to be below the quantitative target (3%).

A greater than expected drop in inflation, and its causes

As a basis for making monetary policy decisions, the Board of Directors and the technical staff at Banco de la República make a detailed analysis of recent and expected behavior of the economy each month, especially regarding the growth of output and employment, inflation, and financial variables. In recent meetings, this effort has focused on understanding the reasons why growth and inflation are significantly lower than we expected two quarters ago.

In our analysis of the variables that factored into a slower GDP growth than we expected, the behavior of external variables was close to what we had foreseen. The growth of trading partners, levels of terms of trade and foreign investment values were similar to those expected in the first half of 2012. The real total exports have indeed grown at a rate slightly lower than anticipated by the impact of crude oil transportation problems and the production of coffee lower than expected.

The behavior of household consumption hasn't been a surprise either. This variable grew at a real annual rate of 4% in the third quarter, in line with that predicted by the technical staff. The fall in consumption of durable goods was higher than expected, and was offset by the greater dynamism of consumption of services. The 4% real growth in household consumption is consistent with a slower rate of household leverage and the convergence of their debt to a sustainable path. For its part, the government consumption growth has been slightly higher than anticipated.

Consequently, the surprising lower growth in 2012 is explained almost entirely by lower investment growth. Within this area, the sluggishness of the construction of civil works, housing, and transport equipment stand out. The industrial and construction sectors also showed unexpectedly weak dynamics. Meanwhile, investment in machinery and equipment maintained an important dynamic, growing at an annual rate of nearly 10%.

In civil works, bad results concentrated in the third quarter, with an unanticipated decline explained (possibly, as some have said) by difficulties in the implementation of public and private works, and to increases in environmental licensing requirements and bottlenecks in approving them, as well as delays in land acquisition. However, given the excessive volatility of this data, its interpretation and forecasting is particularly difficult.

In the construction sector, several factors could explain the greater than expected deceleration. The poor performance of the sector has been observed in several cities, including Bogotá, where different sources of information suggest that the problem is partly due to a restriction in supply. The slowdown in job creation and high housing prices could also be adversely affecting the dynamism of this sector's demand. All this occurs in a context in which families recorded high levels of debt (measured as the ratio of consumption credit plus mortgages to GDP).

As for consumer inflation, price variations were lower than expected in the fourth quarter of 2012 and January 2013, and focused on food and regulated prices. In the first case, this is due to better weather conditions than those recorded in 2011, an unexpected reduction in international prices of imported food, moderate increases in agricultural input costs and the appreciation of the peso.

The lower increase in regulated prices was due to small adjustments in international oil prices and fuel, which furthermore were reflected in prices of gasoline, natural gas and electricity at a faster rate than we expected. Also, we did not anticipate cuts enacted by some local governments to urban transport fares and other public services.

Monetary policy implications

In summary, the recent economic slowdown was partly a necessary correction of consumption and household debt that threatened in 2011 to become unsustainable. This was further affected by weak global growth, which was mostly expected in our forecasts. Considering these factors, a year ago we anticipated GDP growth in 2012 to be lower than in 2011, by about one percentage point (5%). Nevertheless, the decline in growth was higher than expected and we now anticipate growth to close to 3.6%, largely explained by the negative behavior of investment in civil works and housing construction. There are several reasons for this clash, some with short-term effects and others with effects of indefinite duration.

As a result, the economy began to operate below capacity. At the same time, inflation was surprisingly below the target of 3%, mainly due to internal and external supply shocks of variable, and in some cases uncertain, duration. In this context, in order to stabilize the level of output around the capacity of the economy and ensure the convergence of inflation to the target, the Board of Directors reduced the interest rate from 5.25% in June 2012 to 4% in January 2013.

The reduction of interest rates has been gradual (of 25 basis points each time), given the uncertainty about the nature and duration of the shocks that have determined the behavior of prices and output, as well as the risk of financial imbalances (an excessive increase in household credit and real estate prices). If several of these shocks are reversed in the short run, and the probability of a collapse in the international environment is less than it was a few months ago, then the required monetary stimulus should be modest. Under these conditions, trying to bring inflation quickly back to the target implies a very high risk of abruptly changing the stance of monetary policy, and introducing excessive and unnecessary volatility in output and employment.

On the contrary, if the shocks described above exhibit greater persistence and affect prices, inflation expectations, or spending decisions of households and firms, then the necessary monetary stimulus should be stronger. The need for additional adjustments in the policy stance will be determined by the extent to which new information will help to clarify the uncertainty previously described, and by a careful assessment of the risk of future financial imbalances.

Intervention in the foreign exchange market

The other major policy decision was to accelerate the accumulation of international reserves. In mid-2012, the Central Bank was buying, on average, $400 million USD per month. In the fourth quarter of that year the Bank went on to buy $500 million USD per month, and this past January, the Board raised the amount to at least $750 million USD on a monthly average. Accordingly, the Bank is now accumulating international reserves at a rate that is nearly twice that of a year ago, and the country's international reserves will exceed $40 billion USD in the coming months.

Why did the Board of Directors increase the monthly rate of accumulation of international reserves? The continued growth of the economy, its financial deepening and its increasing integration into the global economy increase the risk of international liquidity, which should be controlled with higher levels of international reserves. The current economic and exchange-rate market conditions present an opportunity to increase the levels of reserves in a responsible manner, without jeopardizing the achievement of the inflation target and the contributions of monetary policy to the stability of output and employment around their sustainable levels. Two current characteristics of the Colombian economy are of particular importance.

First, the Bank's Board of Directors has reduced interest rates and does not expect to have to raise them in the immediate future. This will minimize potential conflicts between the signals and effects of monetary and exchange rate policies. In contrast, in a period of increasing interest rates, strong interventions can compromise the effectiveness of the policies and the actual hike in rates.

Second, the probability that the real exchange rate is "misaligned" from its equilibrium value is now greater than it was several quarters ago. For example, the terms of trade, which increased every year since 2003, remained relatively stable in 2012 and have recently fallen due to the declining prices of coal and coffee, among others. This should lead to a more depreciated equilibrium real exchange rate. The same effect could be expected of the stability of government spending as a percentage of GDP and of the differential of industrial productivity in Colombia and the United States.

Under these conditions, the Board has seen fit to increase the level of international reserves and improve its indicators. It has been doing so for more than a year, increasing the average monthly purchases according to the technical staff's diagnosis that the probability of a short-term "misalignment" in the exchange rate has increased. The Board does so taking into account calculations of the capacity that Banco de la República has to offset the effects of an increase in the monetary supply, and its impact on the Central Bank's balance sheet. Furthermore, the national government has pledged to save in a fund abroad and Ecopetrol has announced that some of its debt will be issued in pesos and not in foreign currencies.