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"COLOMBIA: IS THERE ROOM FOR FURTHER MONETARY EASING"

JOSÉ DARÍO URIBE, GOVERNOR
BANCO DE LA REPÚBLICA

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Good morning. It is my pleasure to participate in this talk organized by JP Morgan. I was assigned the task of answering the following question: is there room for further monetary easing in Colombia? Colombian monetary policies are defined within the flexible inflation target framework, taking into account all relevant information available at the time of the decision, so the short answer to this question is: we shall see.

But of course, my talk does not end here. In this presentation I explain the recent decision of the Board of Directors of the Central Bank to lower the policy interest rate from 5.25% to 3.75%, lower than anyone expected in mid 2012. In the first section of this presentation, I will examine why the growth rate of the Colombian economy in 2012 was lower than expected, and why the growth projected for 2013 is also likely to be below the full potential. In the second section, I will explain why inflation has fallen far below the long-term target of 3%. I will then talk about the monetary policy implications of these phenomena, and will conclude by identifying the considerations that must be taken into account to determine whether to further reduce the interest rate.

Annual GDP growth and inflation are lower than expected

At the end of 2011, the Colombian economy was characterized by a strong growth in aggregate expenditure and domestic indebtedness, 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 domestic 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 in each of the first two Board sessions of 2012, so that in February of that year 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%. The Central Bank 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 February of 2013, it was measured at a steady rate of 1.8%, below the inferior limit of the inflation target defined by the Board of Directors of the Bank (2%). 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 growth and inflation, and their 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 February 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 3.75% in February 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.

Is there room for further monetary loosening in Colombia?

The scope for additional monetary loosening in Colombia is difficult to assess in the highly uncertain environment in which policy is currently made. However, I can provide some criteria to inform an answer in this respect, based on the determinants of an expanded, forward-looking Taylor rule.

In this setting, the policy interest rate depends on factors such as the expected future deviations of inflation from target, the degree to which productive capacity is used, the estimation of the so called natural interest rate and the risks to the financial stability of the economy. These criteria must be complemented with an examination of the transmission of monetary policy changes to the relevant market interest rates. In the following section, I will review these factors.

i. Expected future inflation deviations from target and capacity utilization: As explained above, the behavior of inflation and output in the coming months will be determined by the nature and duration of the supply and demand shocks that have recently hit the economy. Transitory shocks will not require large additional decreases in policy interest rates. Longer-lived shocks or short term shocks with lasting effects (e.g. through expectations) could entail larger reductions in interest rates. The new information on output, expenditure and prices is crucial to understand the nature of the shocks and their effects. Also, new shocks may appear that reinforce or subdue the shift in monetary policy. For example, weaker external demand for Colombian exports may strengthen the case for further monetary loosening.

ii. The natural interest rate: The stance of monetary policy is typically measured as the distance between the real policy interest rate and its natural level. The latter is an unobservable variable and, consequently, it is difficult to offer a reliable

assessment on its value. It is, perhaps, easier to discuss its expected future changes.

In an open economy like Colombia changes in the natural interest rate must be related to movements of the external natural rate and to shifts of the sustainable levels of the sovereign risk premium and the expectations of depreciation of the COP. Monetary policy and weak aggregate expenditure in advanced economies are likely to ensure very low levels of both natural and observed external interest rates. The sovereign risk premiums in emerging economies have remained tight in recent months and no large real depreciations of emerging market currencies are expected. Hence, one could conclude that the natural level of the interest rate will probably remain roughly unchanged in the near future.

Nevertheless, one must question whether the prevailing external conditions for emerging economies are sustainable. Analysts have raised concerns in this regard. Have the emerging economies' risk premiums reached unwarranted low levels? If this were the case, then both the risk premium and the expectations of depreciation of the currency could be underestimated. Consequently, conditions may change suddenly and rapidly and therefore, prudent policy must not rely on the assumption of a low, stable natural interest rate.

iii. Risks to financial stability: One source of concern for monetary policy in Colombia between 2011 and the first part of 2012 was a worrisome trend of domestic credit growth and the fast increase in house prices. Credit growth has abated, although it remains above nominal GDP growth. House prices keep rising in real terms, even in the midst of the economy-wide slow down. In this context, keeping low interest rates for too long entail the risk of a resumption of dangerous dynamics in leverage and asset prices. This risk, however, seems to be currently mitigated by the behavior of financial conditions, as will be discussed next.

iv. Monetary policy transmission: Shifts in policy interest rates are transmitted to the longer-term market interest rates through several channels. One is the expectations channel. When the market perceives that macroeconomic conditions grant a pronounced or prolonged cycle of decreasing or increasing policy rates, then transmission tends to be stronger, and vice versa.

Another channel runs through the impact of policy rate changes on risk premiums of the different financial products of the economy. These risk premiums are endogenous variables that depend on the perceptions of investors and lenders about the volatility of the economy in the future.

When policy interest rate shifts are cautious due to the uncertainty about the nature and duration of shocks and the level of the natural interest rate, or because of risks to financial stability, transmission may be subdued. In this case, both the expectations and the risk premiums channels imply low responses of market interest rates. Market participants may not anticipate strong, long-lasting movements of policy rates. Similarly, market participants may perceive that movements in the policy rates are too timid to concentrate macroeconomic scenarios around a more favorable path. In these circumstances, additional, stronger movements in the policy rate may be warranted to achieve the goals of monetary policy.

A simple examination of the current cycle of reductions of policy rates reveals a transmission to loan and deposit rates that is slower that in the past two cycles of changes in the monetary policy stance. This implies, first, a mitigation of the risk to financial stability (e.g. consumer loan interest rates have hardly changed since the beginning of the loosening cycle), and second, a need to closely monitor the transmission in the near future to assess the convenience of further loosening policy.

In sum, to the extent that the shocks that have hit the economy in recent months have persistent effects on inflation expectations and aggregate demand, there could be further scope for monetary policy loosening in Colombia. This conclusion is reinforced by the decreased risk of financial instability resulting from the gradual normalization of credit growth and by the relatively slow transmission of the policy interest rate reductions so far. However, the potential scope for monetary easing would be limited by a prudent attitude of policy makers toward the current loose external financial conditions.