HOW LONG SHOULD LOW INTEREST RATES BE SUSTAINED? COLOMBIA IN THE CONTEXT OF LATIN AMERICA

José Darío Uribe[1]

Latin American economies experienced a serious shock to their income as a result of the global crisis. Both their terms of trade and exported volumes dropped markedly while their GDP fell with the global recession and the collapse of world trade (Table 1). Remittances from workers abroad, an important source of national income for some countries, also plunged. Heightened risk aversion after the Lehman bankruptcy meant larger sovereign risk premiums, currency depreciation and falling asset prices in these economies (Graphs 1-3).

TABLE 1

A. TERMS OF TRADE (FOR GOODS AND SERVICES)
(Index 2000=100)

	2004	2005	2006	2007	2008
BRASIL	98,3	102,1	108,6	112,4	118,4
CHILE	118,4	130,9	166,2	169,3	148,7
COLOMBIA	101,0	110,7	114,7	124,3	136,9
MEXICO	100,6	103,1	103,8	104,8	105,5
PERU	108,6	116,9	144,9	150,4	133,9

Source: CEPAL

B. VOLUME OF EXPORTS OF GOODS
(Index 2000=100)

	2004	2005	2006	2007	2008
BRASIL	163,8	178,5	184,8	195	n.d.
CHILE	135,7	141,1	145,4	155,3	n.d.
COLOMBIA	116,4	127,7	135,7	143,3	n.d.
MEXICO	105,1	112	124,4	126,5	n.d.
PERU	152,4	175,1	175,5	179,5	n.d.

Source: CEPAL

C. GROSS DOMESTIC PRODUCT
Annual percent change

	2004	2005	2006	2007	2008	2009*
BRASIL	5,7	3,2	4,0	5,7	5,1	(1,50)
CHILE	6,0	5,6	4,6	4,7	3,2	(3,40)
COLOMBIA	4,9	4,7	6,8	7,5	2,5	(0,35)
MEXICO	4,0	3,2	5,1	3,3	1,3	(9,15)
PERU	5,0	6,8	7,7	8,9	9,8	0,35

Source: International Monetary Fund, World Economic Outlook Database -WEO- April 2009. DANE for Colombia.
* First Semester

Memo Items:

(Annual percent change)	2004	2005	2006	2007	2008
World Real GDP	4,9	4,5	5,1	5,2	3,0
World Trade Volume (goods and services)	10,7	7,8	9,1	7,3	3,0

Source: WEO, April 2009.

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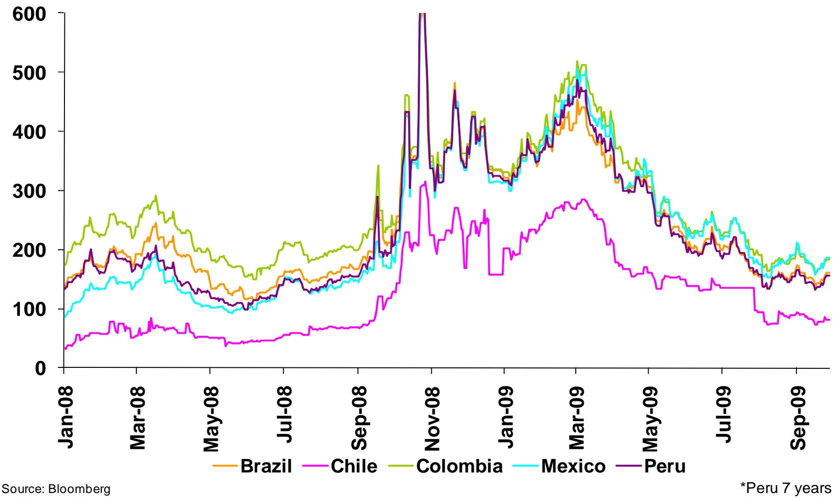
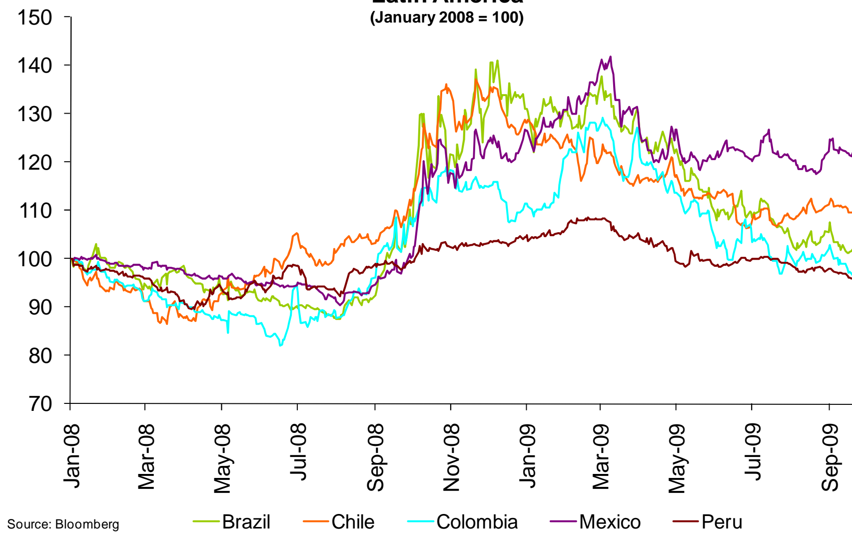
[1] Governor of Banco de la República (Central Bank of Colombia)

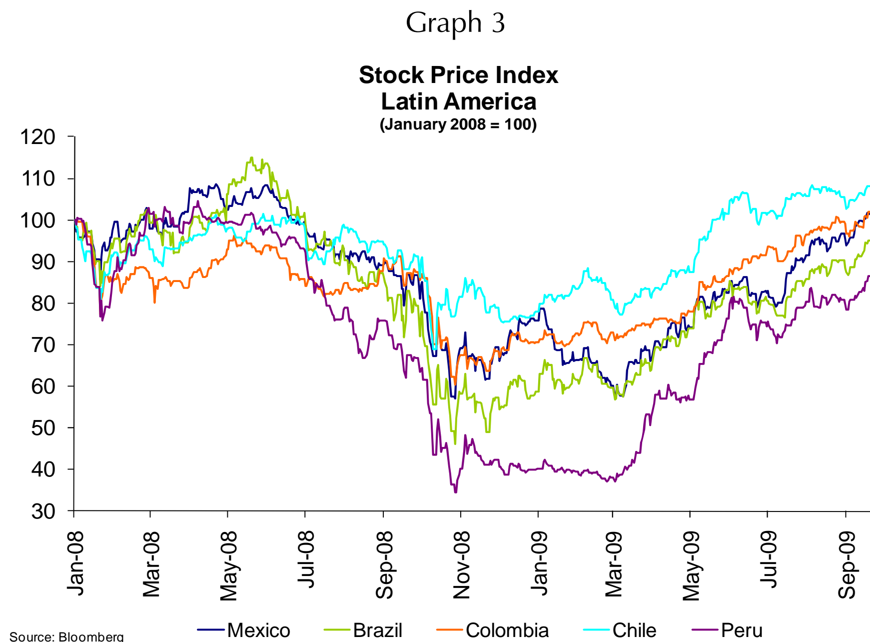
Graph 1



Graph 2



Graph 3

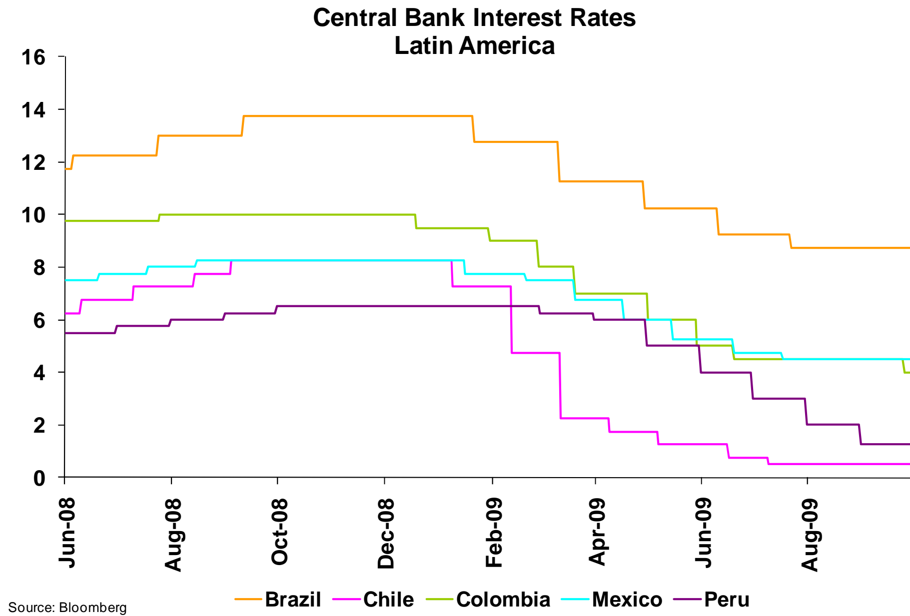


The challenges facing the monetary authorities changed abruptly from containing inflationary pressures related to rising food and raw material prices to smoothing the effects of rapidly declining incomes. Initially the high levels of inflation, the depreciation of the currencies and the uncertainty about the extent of the damage brought about by the crisis prevented the central banks from acting aggressively. However, starting in December 2008, most of them have made sharp reductions in their policy interest rates (Graph 4).

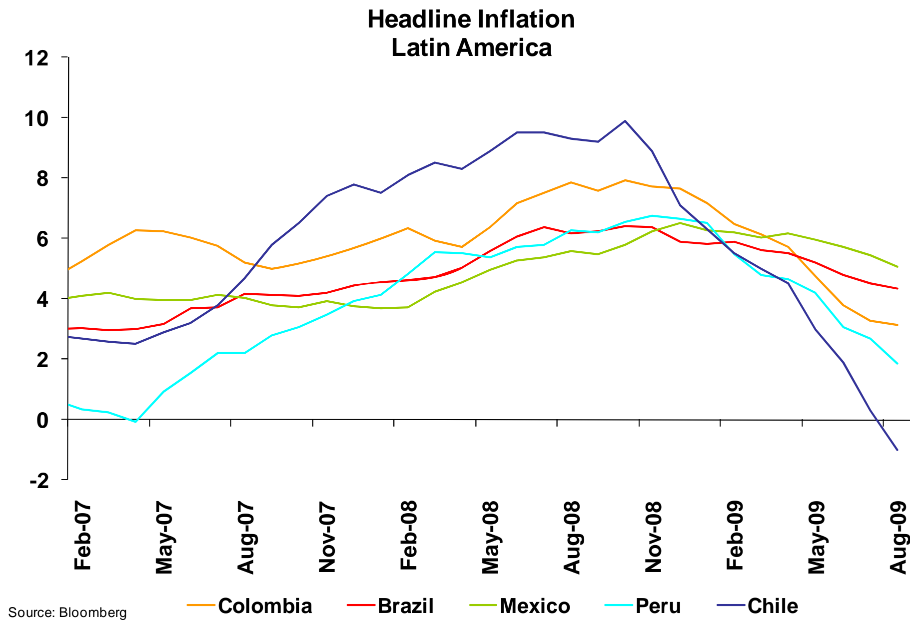
This was an unprecedented response, for in the past, currency mismatches or the existence of pegged exchange rate regimes had forced the central banks of these economies to tighten monetary policy in the midst of an external shock that induced a depreciation of the currency. The reversal of the relative price shocks of 2007-2008 and the widening output gaps produced a sharp correction of inflation (Graph 5) that, together with low pass-through and low currency mismatches, permitted the aforementioned strong response by the central banks in the region.

Interest rates have reached historically low levels in several countries as a result of this countercyclical monetary policy. The question naturally arises as to how long the low interest rates should be sustained. Unlike several developed economies, the financial system in these countries has remained strong in spite of the decline of output and expenditure. Hence, the credit supply has not undergone the protracted, impairing interruptions that typically follow financial crises.

Graph 4



Graph 5



This is a key difference between the prospects for monetary policy in the region and in other parts of the world. Provided that a global depression has been avoided, it is likely that the financial systems in Latin America will endure the world recession and that once demand picks up, credit will flow to firms and households to support growth. Accordingly, the need

for a sustained expansionary monetary policy in the region will not be determined by domestic financial system factors.

Future monetary policy in Latin America will evidently be affected by the shape of the recovery of the World economy. So far, the large economies have stabilized thanks to huge public interventions and the build-up of inventories. The effects of the former will taper off while the second will sustain demand only temporarily. The risk, therefore, is that private consumption and investment spending do not grow fast enough to support the recovery afterwards. In this case, external conditions for Latin America would remain weak and monetary policy would probably continue to be largely accommodative. Export demand would be frail, export prices would be relatively low, international risk aversion would remain high, all of which would imply negative output gaps, slowly appreciating currencies and insignificant inflationary pressures.

On the other hand, if the world economic recovery proves to be sustained, the picture could rapidly change for Latin American central banks. Export demand and terms of trade would improve, output gaps would close and inflationary pressures could reappear due to demand and commodity price increases. In response, monetary policy would have to be tightened. The extent and the speed of such an adjustment would share some common determinants, but would generally vary across the countries of the region depending on their particular conditions.

Common Factors

One common factor behind monetary policy response has to do with the "natural" level of the real interest rate facing these countries. Ours are after all small open economies for which the "natural" rate of interest is related to the world "natural" risk-free interest rate. In a recovery scenario the latter will probably rise, as fiscal imbalances in crisis countries concur with larger credit demand from households and firms.

This factor, however, may be partially offset by lower sovereign risk premiums stemming from decreased global risk aversion. Indeed, risk premiums have already shown a significant correction from their post-Lehman crisis levels (Graph 1), but additional declines are possible in a recovery scenario. Together these common factors could lead to an increase in interest rates that depends on the strength of the recovery.

Country-Specific Factors

Latin American countries differ in the size and sign of inflation deviations with respect to its long run target (Table 2). Countries like Chile and Perú have inflation rates below or close to the lower end of their target ranges while in Brazil and México inflation still exceeds or is closer to the upper end of their target ranges. In Colombia headline inflation is on its long run target, but core inflation is still close to the upper boundary of the target range. It may be argued that policy rates would react faster and to a greater extent in those countries where inflation is above target.

However, this conclusion must be examined carefully since the very fact that inflation undershot the targets may be an indication of a higher degree of price flexibility. And, if this were the case, policy rates would probably have to react *faster*, not slower, in the event of a recovery. The contrasting behavior of inflation in Chile and México may provide an indication in this regard (Graph 5).

Table 2

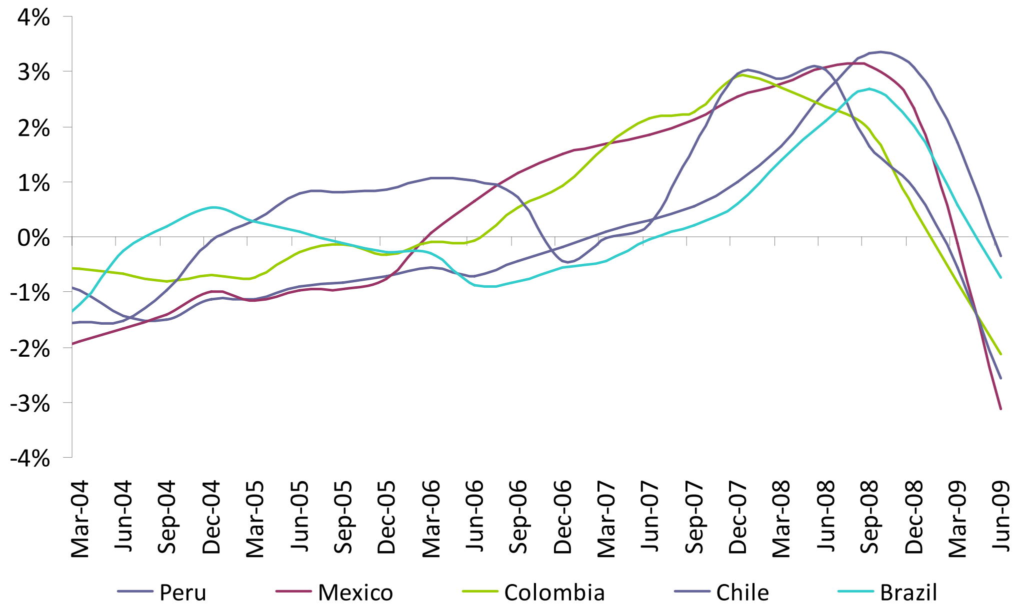
	Headline Inflation	Core Inflation a/	2009 Inflation Target	Long Run Inflation Target
Chile	-1	0,4	(2,0 -4,0)	3,0
Brazil	4,36	5,32 +	(2,5 - 6,5)	-
Mexico	5,08	5,1	(2,0 -4,0)	3,0
Peru	1,87	1,4 +	(1,0 - 3,0)	-
Colombia	3,13	3,97	(4,5 - 5,5)	3,0

a/ Index Without Food and Energy
\+ Index Without Food

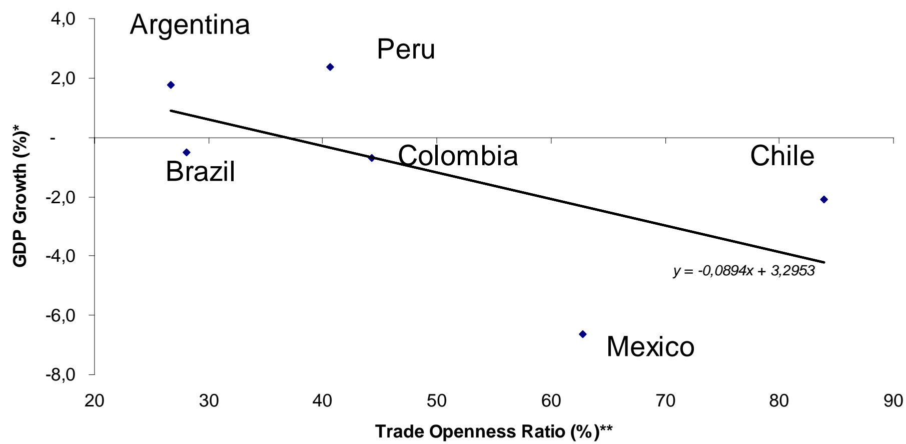
Source: Central Banks and Bloomberg

The current and projected size of the output gaps will also determine the timing and extent of monetary policy tightening. A naïve calculation of the current output gaps based on Hodrick-Prescott filters shows a larger slack in Chile and México (Graph 6). Nonetheless, the output gap may be closed faster in these countries in the future because they are more open and would benefit the most from a world recovery. This is, by the way, the same reason why they suffered larger declines in the recession (Graph 7).

Graph 6



Graph 7



* GDP Growth: Annual variation for the last 3 quarters (Q4 2008, Q1 2009 and Q2 2009)
** Trade Openness ratio: (Exports + Imports) / GDP. Average for 2006-07
Source: CEPAL

The improvement in the terms of trade that follows a global upturn would stimulate expenditure in our economies. Nevertheless, the size of this effect may differ across countries, depending on the composition of their import and export baskets, the distribution of the commodity price increases, the structure of the ownership of commodity export income (foreign/domestic or public/private) and the presence of stabilization funds.

Furthermore, the recession may have had different effects on potential output across the region. Investment ratios during 2006-2009 have declined to different degrees in the countries examined (Table 5) which implies diverging impacts on potential GDP and on the tolerance of the various economies to expenditure pressures.

Table 5

A. Gross Investment as a Percentage of GDP

	2006	**2007**	**2008**	**2009 (1Q)**
BRAZIL	16%	18%	20%	17%
CHILE	25%	27%	30%	20%
COLOMBIA	25%	26%	28%	27%
MEXICO	23%	23%	24%	21%
PERU *	19%	21%	26%	24%

Source: CEPAL

Source*: Central Reserve Bank of Peru

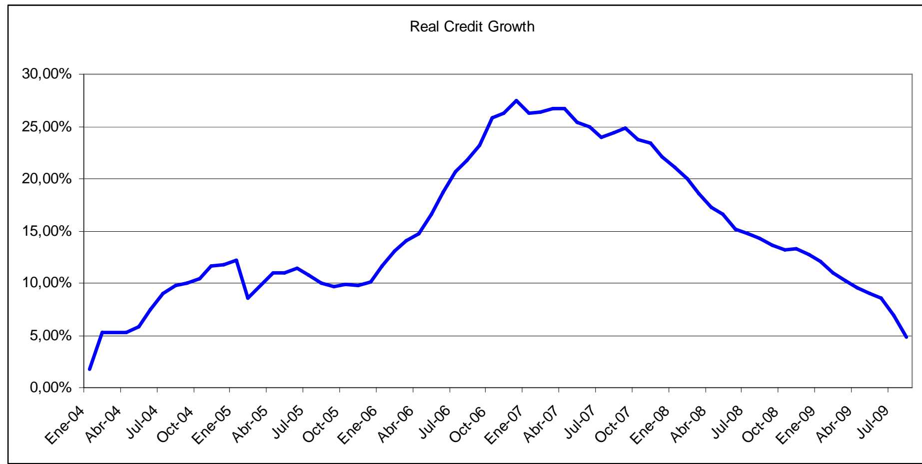
The behavior of the exchange rate could also differ across countries in a recovery. Although it is likely that all currencies in the region would appreciate given the relatively weaker fiscal and monetary position of the U.S. and other developed economies, varying terms of trade and growth gains would mean different external revenue, FDI inflows and rates of appreciation. Naturally, these factors would have a varying impact on the behavior of inflation and the monetary policy response.

Finally, the countercyclical monetary-fiscal policy mix adopted in each country would also determine future central bank behavior. In those economies where the discretionary component of the fiscal policy response was smaller, a larger burden of the countercyclical policy was placed on monetary policy. This means that in the event of a recovery, policy interest rates may have to be raised faster in these countries unless the authorities were to enact discretionary countercyclical measures for the upswing.

Colombia

The previous thoughts are useful for understanding the case of Colombia in the context of comparable countries in the region. To begin with, the Colombian Financial System has remained strong throughout the economic downturn. Credit growth is declining mostly as a result of a slowdown in credit demand, but still shows positive and high real rates (Graph 8).

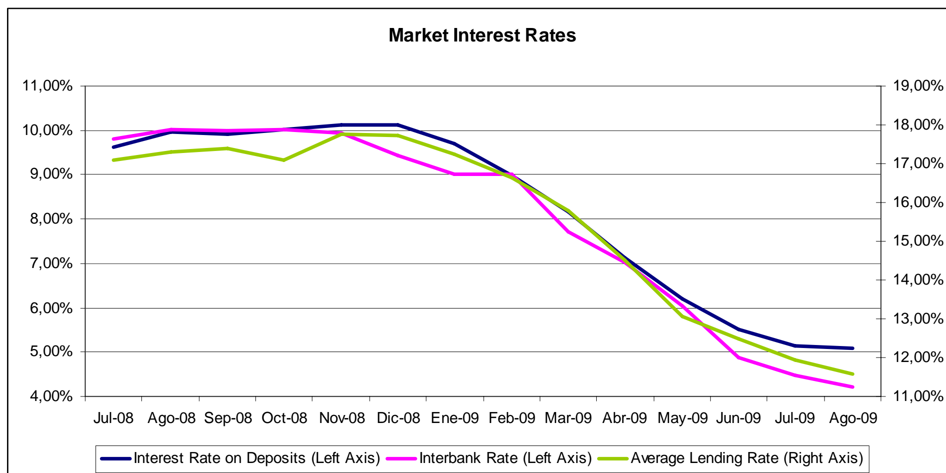
Graph 8



This has two implications. First, financial system weakness is not a key determinant of monetary policy. Second, the transmission mechanisms of monetary policy are still working normally as evidenced by the response of market interest rates to policy rates (Graph 9). Hence, the supply of credit is still flowing adequately and spending decisions are still responsive to monetary impulses.

Regarding the "natural" interest rate, Banco de la República, like the rest of the central banks in the region, will have to accept a higher level in the case of a sustained global recovery.

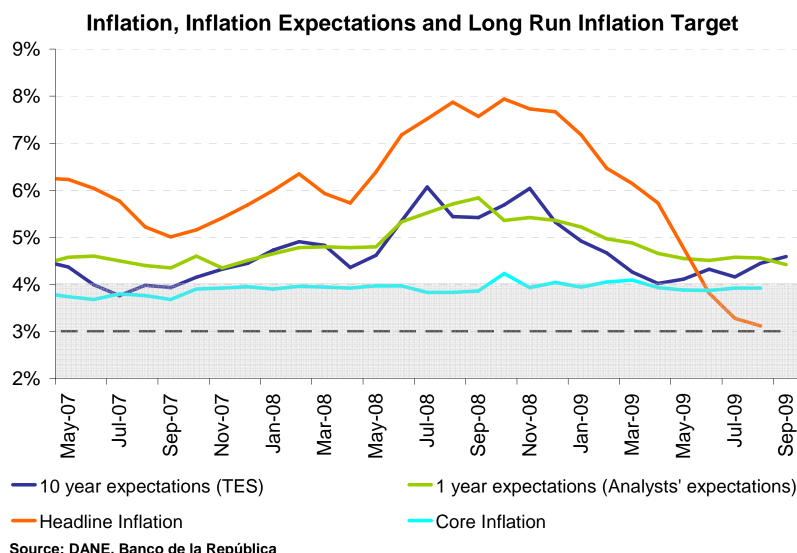
Graph 9



As mentioned before, headline inflation in Colombia is on its long run target, but core inflation measurements and inflation expectations are generally above the long-term target range (Graph 10). The sharp decline of inflation throughout 2009 has been almost entirely due to the undoing of the relative price shocks of 2007-2008. Looking forward, this imposes

limits to expansionary policy and will probably require a prompt reaction on the part of the central bank if the recovery scenario materializes.

Graph 10



Colombia seems to be an intermediate case of price rigidity in the context of the region. About 15.3% of the CPI basket is made up of regulated-price item while an additional 9% could be characterized as "strongly indexed. Food prices are generally not regulated and fluctuate with the international prices, the exchange rate or domestic conditions (weather, crops, demand etc.) The relative stability of the core inflation measurement that excludes food and regulated prices despite the large movements in headline inflation (Graph 10) is an indication of a relatively moderate degree of indexing of past *annual* inflation.

Therefore, a recovery that pushes up output or inflation expectations would probably require a response by Banco de la República that, in the region, could also be characterized as "intermediate."

The output gap in Colombia fell from an estimate of around 1% in 2008 to approximately -2.5% in 2009. Even so, growth in Colombia has exhibited one of the most muted responses in the region (Table 1). Although this may reflect the fact that Colombia was starting to experience a slowdown *before* the global crisis, it may also be the result of its being a relatively closed economy, its special relationship with Venezuela and progress in public works programs that had been delayed in 2008.

In this sense, the prospects for a rapid correction of the output gap with a global recovery may be more uncertain than in other parts of the region. First, the lack of openness would imply a relatively moderate response to rising global demand. Second, trade with Venezuela

may suffer further interruptions thus involving a serious shock to several manufacturing sectors.

On the other hand, rising commodity prices could encourage additional FDI in the oil and mining sectors (coal and nickel) and would improve the fiscal position. However, the size of the impact of these phenomena on aggregate expenditure is also uncertain. A large part of the additional income goes to multinational companies, the Government is rightly concerned about keeping public debt sustainable and rising commodity prices would raise production costs and hinder the purchasing power of household income.

Investment in Colombia was very strong before the crisis and has remained relatively dynamic during the recession. Together with the previous points on expenditure, this means that the economy could tolerate moderate spending pressures without large inflationary consequences. It also means that expected conditions must improve significantly to induce large increases in investment in some sectors of the economy.

There is also great uncertainty regarding the extent of currency appreciation in the future. Recent oil discoveries and rising oil prices in a recovery would suggest additional pressures for appreciation, especially when investment flows into the country to increase exploration and exploitation. Conversely, declining exports to Venezuela would induce a depreciation of the currency since many firms and sectors would find it difficult to find a substitute for that market.

Finally, counter-cyclical fiscal policy in Colombia was limited to the operation of automatic stabilizers and bringing some public works programs up to date. Insufficient counter-cyclical policy during the boom years meant a limited scope for stabilization during the recession. Thus, monetary policy has sustained the burden of counter-cyclical policy. When external conditions improve, any adjustment of the interest rates will depend on the strength of the recovery and the degree to which the Government pursues discretionary counter-cyclical policies.

In summary, there are factors that point in the direction of an adjustment of policy rates in Colombia depending on the intensity of a world recovery. The facts that core inflation and inflation expectations remain above the middle point of the long run target, prices remain moderately rigid and there is little scope for fiscal policy restraint under current conditions would force an increase in central bank interest rates. Conversely, the uncertainty about the response of the output gap and the exchange rate to a world recovery, especially considering trade disruptions with Venezuela, would involve a more cautious reaction. Only the unfolding of events will unveil the scenario into which the economy is moving.

Istanbul, October 4, 2009