



Monetary Policy Challenges under Tighter External Financial Conditions

FLAR-CAF XIII Annual Conference

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Governor

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Policy challenges

- **External Risks and Policy Challenges**

- **First line** of defense: **Exchange rate flexibility** but there are **preconditions**
 - Limited currency **mismatches**
 - A **credible** monetary regime
 - Sound and robust **financial sector**
 - Sound **fiscal** policy
- **Second line** of defense: External **buffers**

- **Other Policy Challenges**

- Higher participation of **foreign investors** in local public debt market poses other policy challenges.
- Higher **debt**

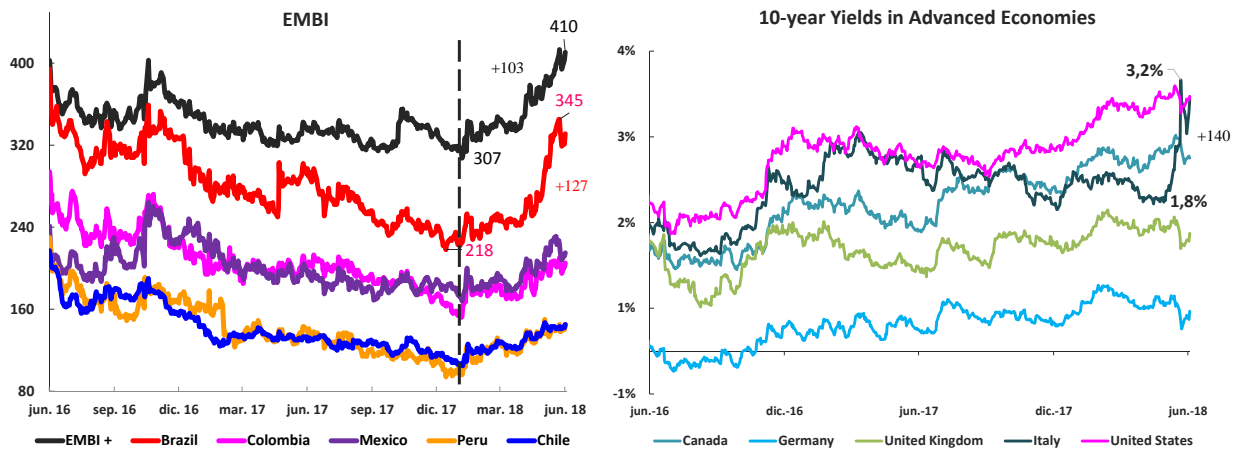
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Current policy challenges are linked to changes in external conditions

- Financial
 - Monetary policy **normalization** in advanced economies
 - Increases in **risk aversion**
 - **USD** appreciation
- Non-financial
 - Decrease in **commodity prices**
 - Changes in international **trade policies**

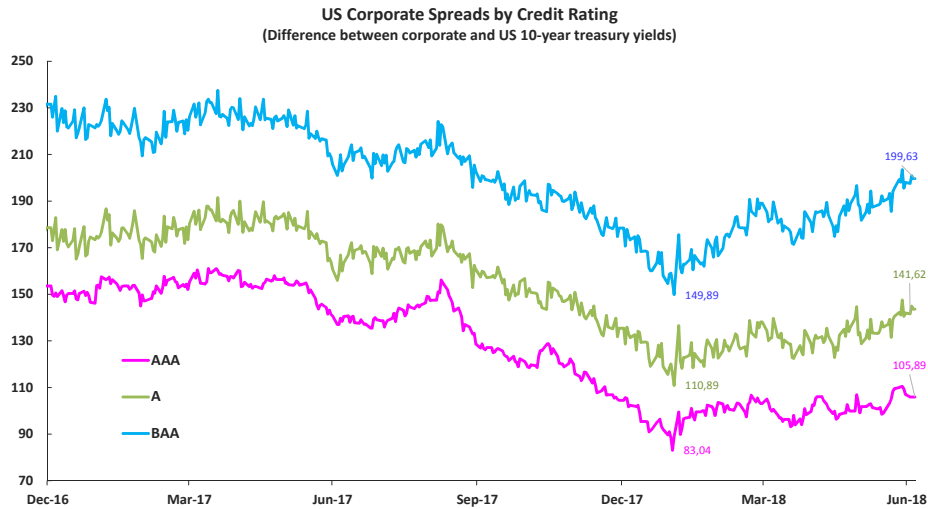
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External risks arise from changes in international financial conditions



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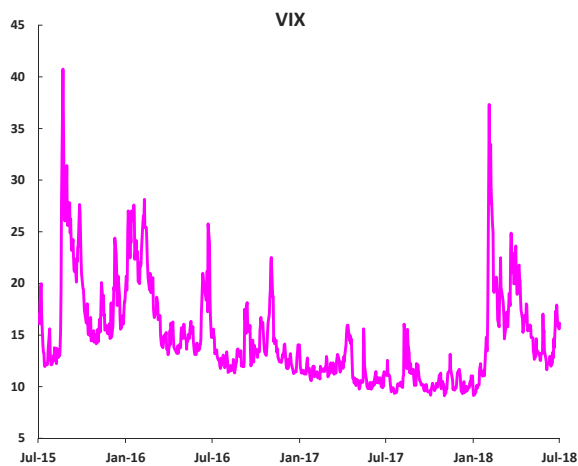
The recent increase in **corporate spreads in US** suggest tighter financial conditions in advanced economies.



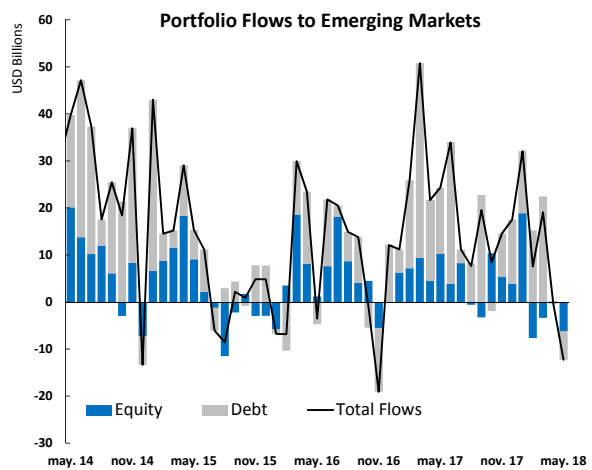
Source: Bloomberg

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Higher financial volatility and lower levels of capital inflows to EM suggest that probably a scenario of tighter international financial conditions is beginning.



Source: Bloomberg and IIF.



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Policy challenges

• External Risks and Policy Challenges

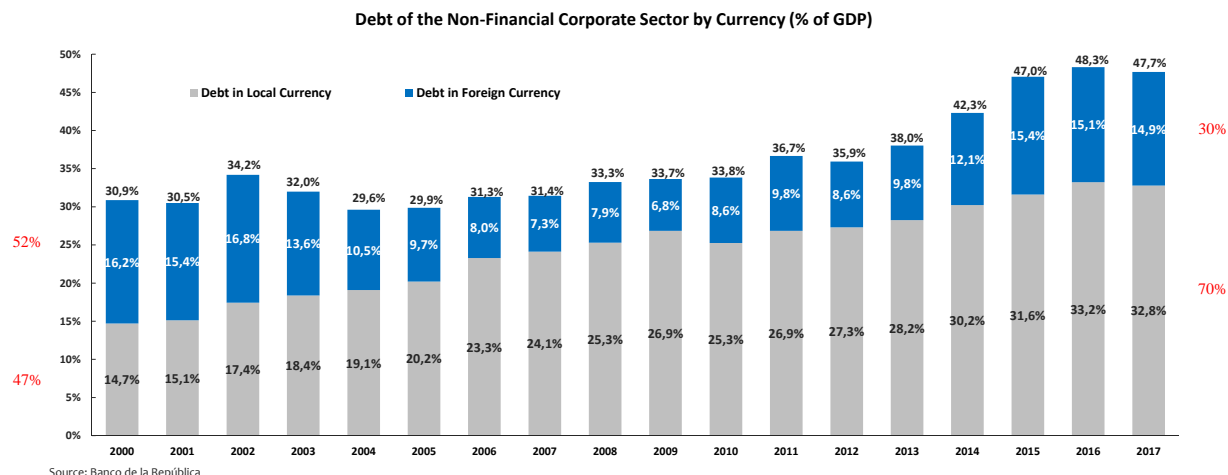
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Currently, debt denominated in foreign currency is not a source of concern. However, we continue monitoring the evolution of private sector indebtedness.

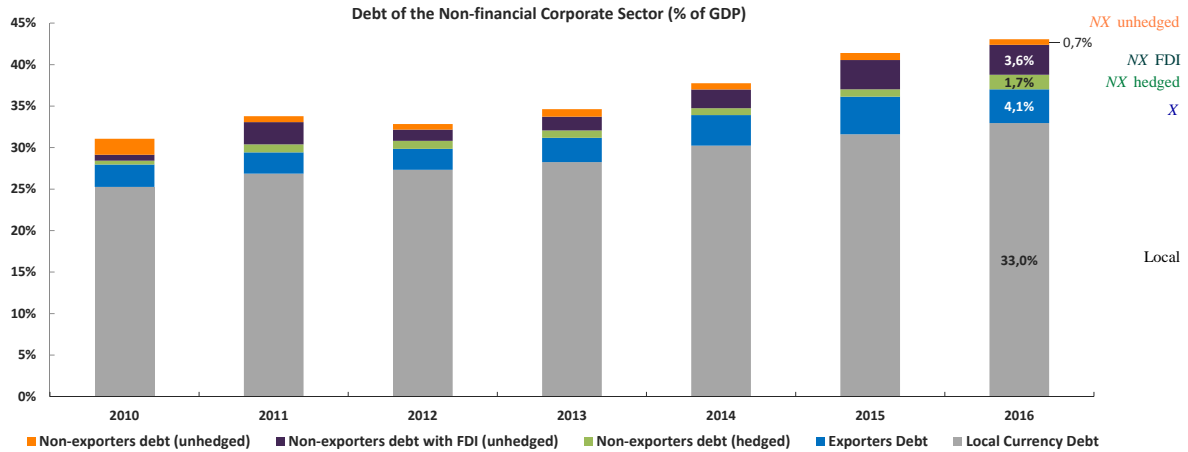


- Financial exposure of households to exchange rate fluctuations is almost null.

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Unhedged corporate external debt represents a small fraction of private sector liabilities

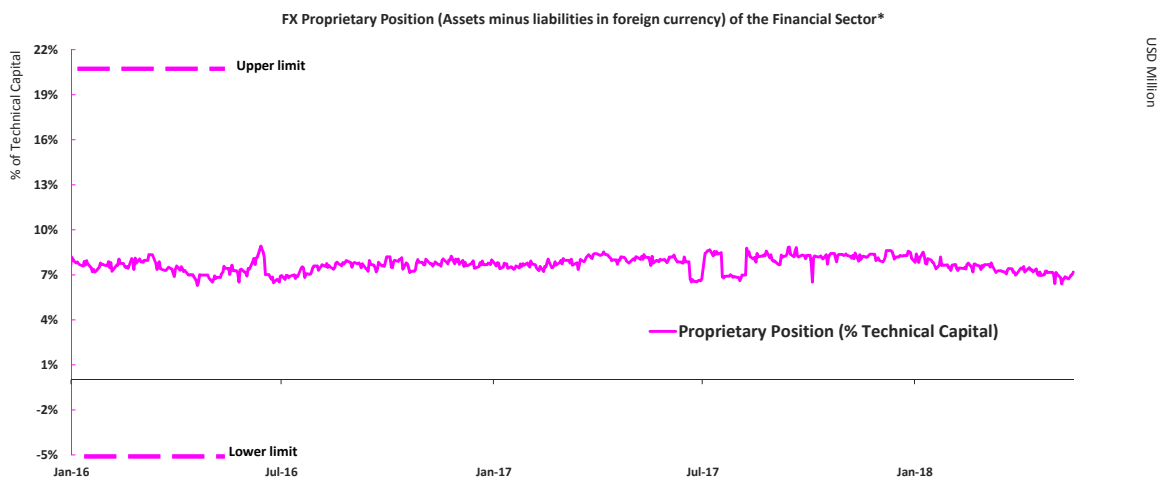
- A large proportion of the debt in foreign currency is either hedged or in hands of exporters, thus reducing the FX risks.



Source: Banco de la República

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The exposure of financial intermediaries to exchange rate risk has kept low and relatively constant during last years:
(non covered net assets of financial intermediaries)

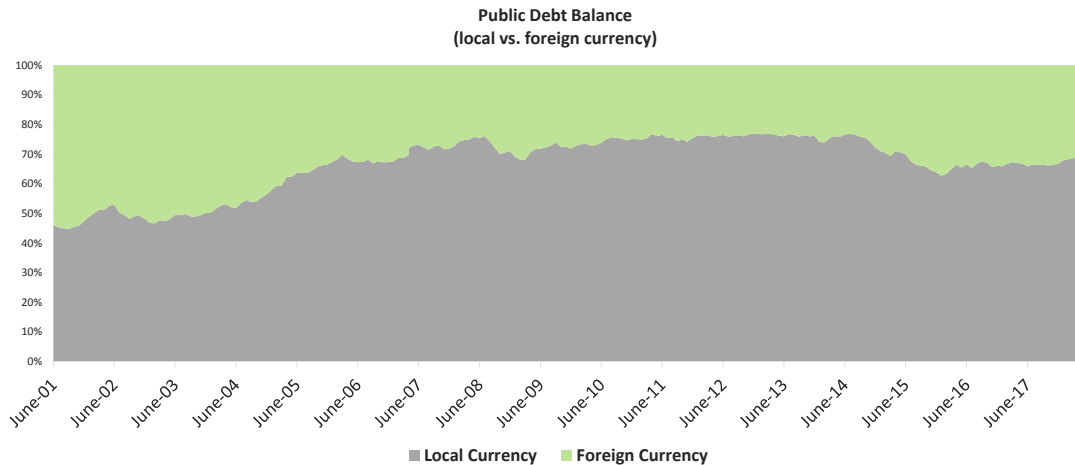


*FX Market Intermediaries: Includes credit establishments and brokerage firms.

Source: Banco de la República

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Public foreign currency debt remains at low levels (% of total public debt)



Source: Banco de la República

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Policy challenges

• External Risks and Policy Challenges

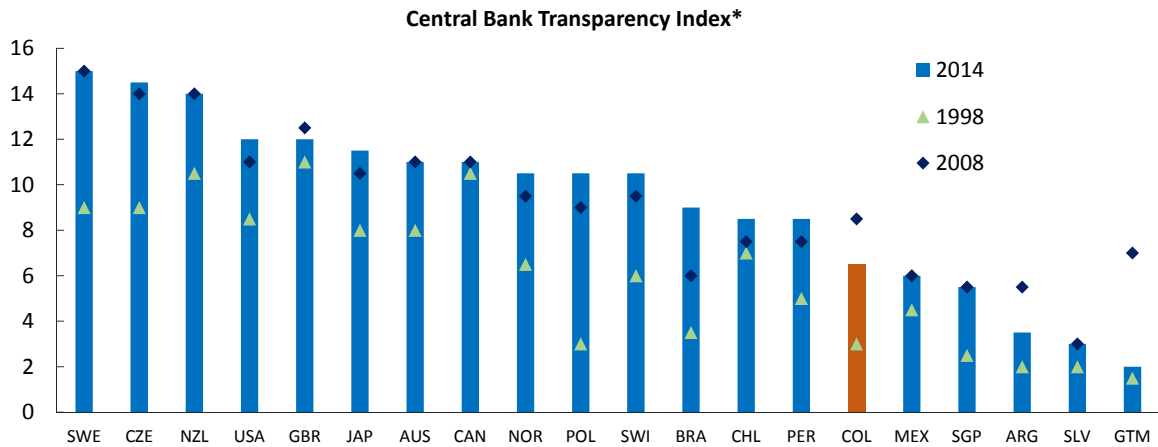
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A credible monetary regime is supported by high levels of transparency and an effective communication.
 Despite some enhancements, there is still a significant room for improvement.

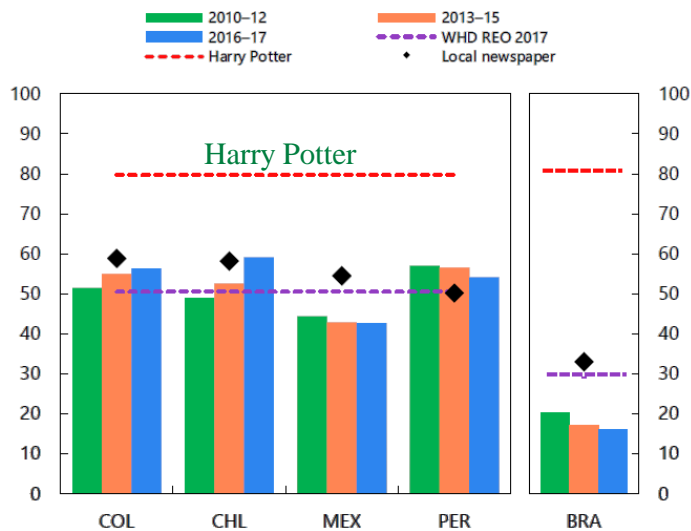


Source: IMF (2018)

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A good comprehension of the Central Bank's communications by the general public supports a credible monetary regime.

Readability of Central Bank Press Releases



Source: IMF (2018)

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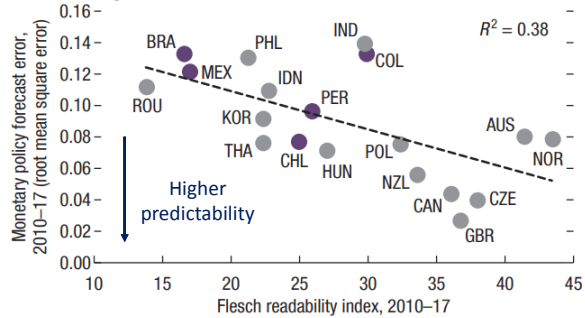
And a better communication allows for higher predictability

Monetary Policy Predictability

Size of Monetary Policy Surprises, 2010–17
(Root mean square error of monetary policy forecasts)



Clarity of Central Bank Communication and Monetary Policy Predictability

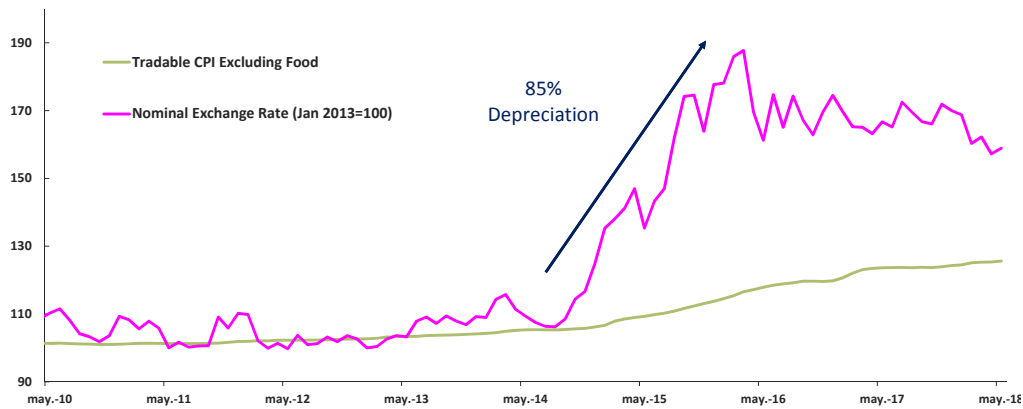


Source: IMF (2018)

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A credible monetary regime supports a low level of pass through from exchange rate to prices

- Exchange rate works as an effective shock absorber if episodes of currency depreciations do not threaten credibility on price stability objectives.
- The 2014-2015 episode showed a relatively small increase in the tradable CPI, despite the large currency depreciation

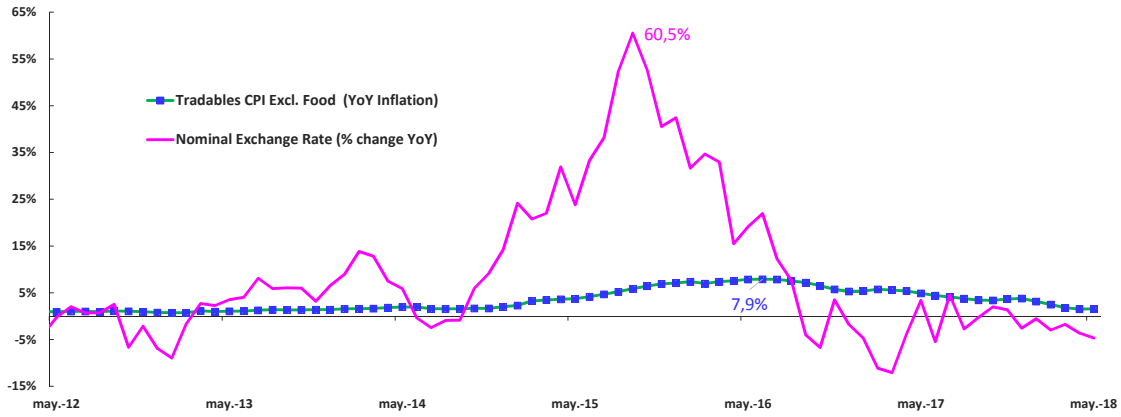


Source: Banco de la República

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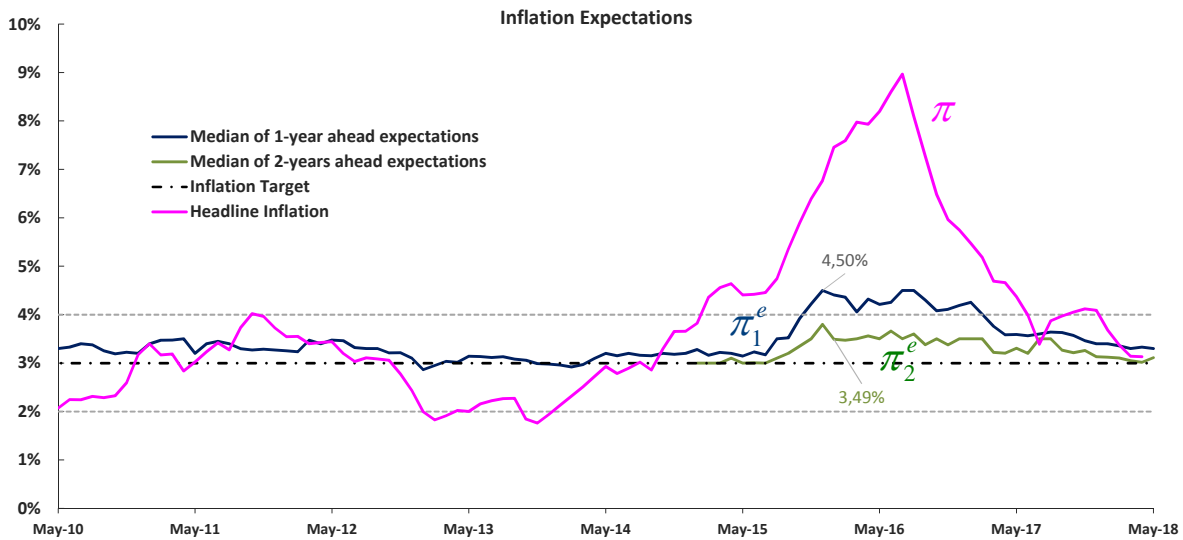
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Source: Banco de la República

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The low pass through could be partially accredited to the credibility of the inflation targeting regime. Therefore, improving communication and transparency is still one big challenge



Source: Banco de la República – Monthly Survey of Economic Expectations

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 - **Sound and robust financial sector**
 - Sound fiscal policy
- Second line of defense: External buffers

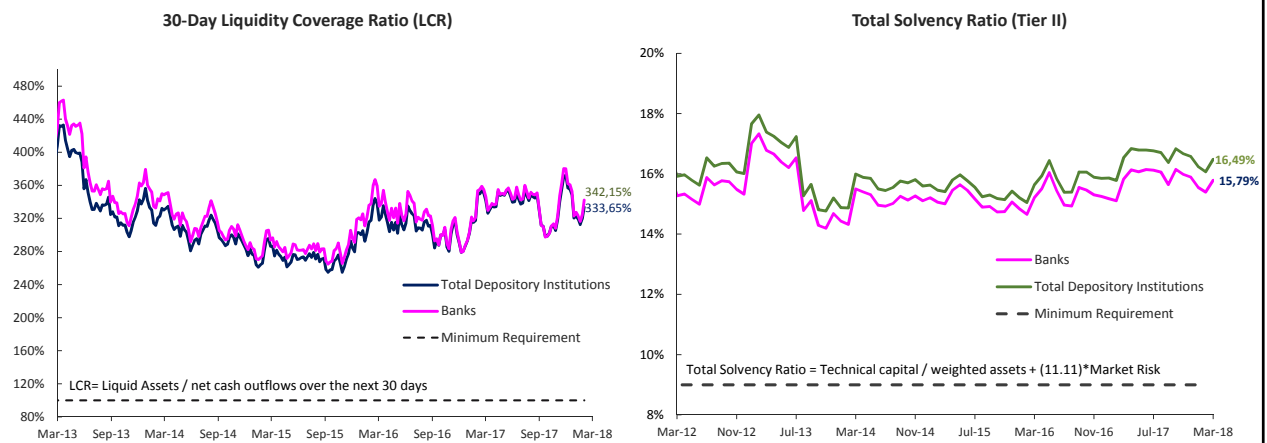
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Local banks are resilient to tighter external conditions

- Throughout the last few years, the Colombian banking system has kept solid liquidity and solvency indicators.
- This has occurred despite the adjustment of the Colombian economy to negative external shocks. At the same time, domestic regulation has contributed to building buffers for credit risk (e.g. dynamic provisioning) and liquidity risk.



Source: Superintendencia Financiera de Colombia. Calculations by Banco de la República.

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Local banks are resilient to tighter external conditions II

- The latest **stress test exercise** simulates the effect of a **full exit of foreign investors from domestic public/private debt markets** together with a significant **fall in GDP growth** (1.3% for 2018).
- Under this extreme scenario the estimated cumulative losses would generate a reduction in Tier 1 Capital Ratio from 11,6% to 9,8% well above the regulatory minimum: 4,5%.

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Policy challenges

• External Risks and Policy Challenges

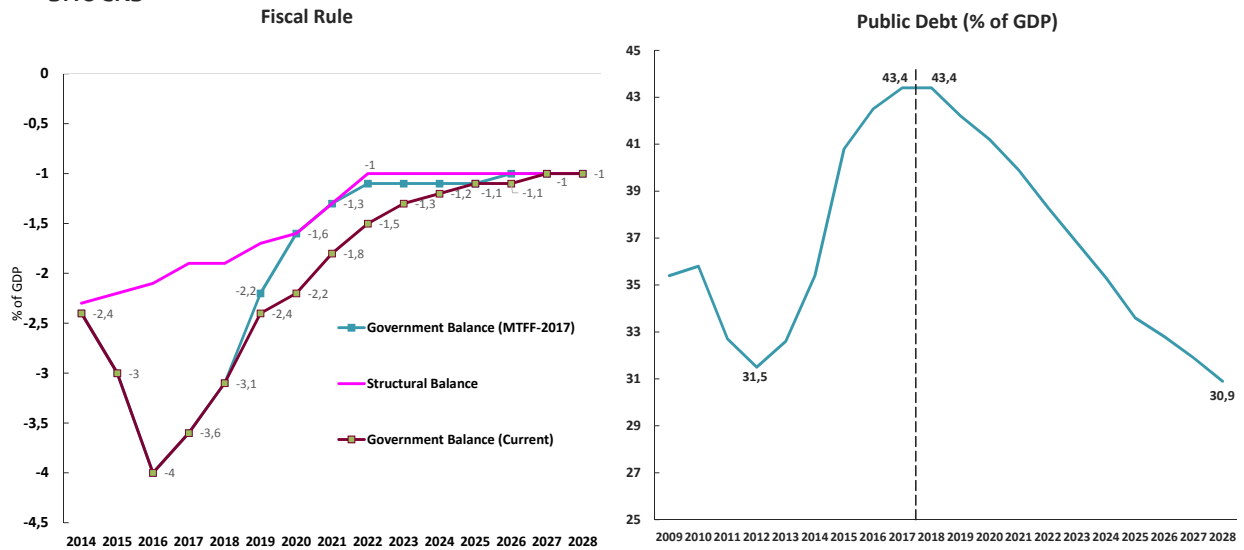
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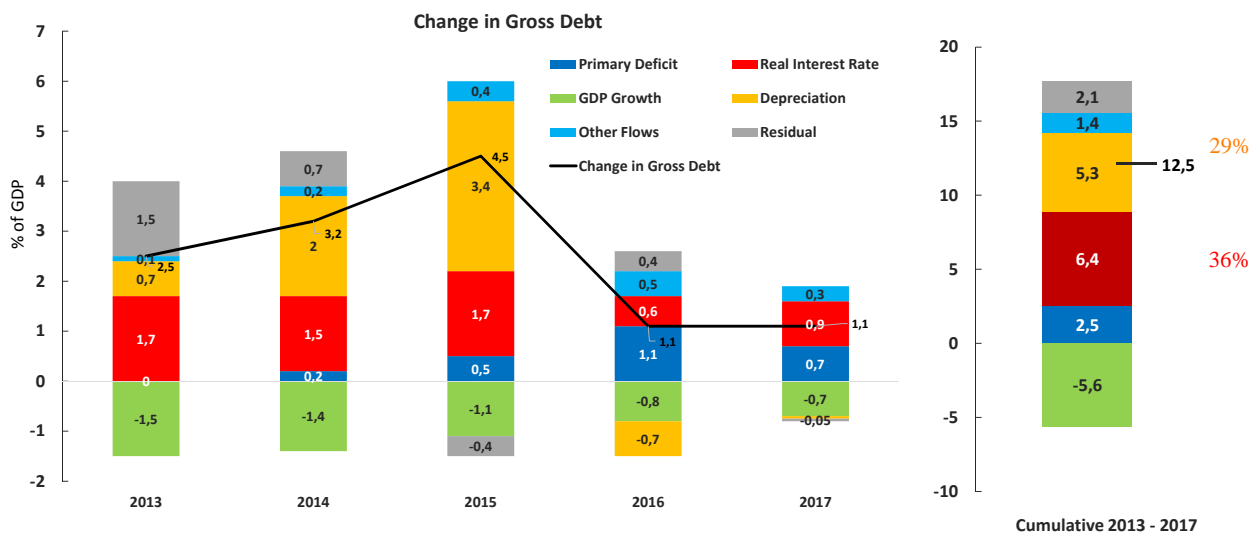
Maintaining a sound and credible fiscal policy lowers the vulnerability to external shocks



Source: Ministry of Finance

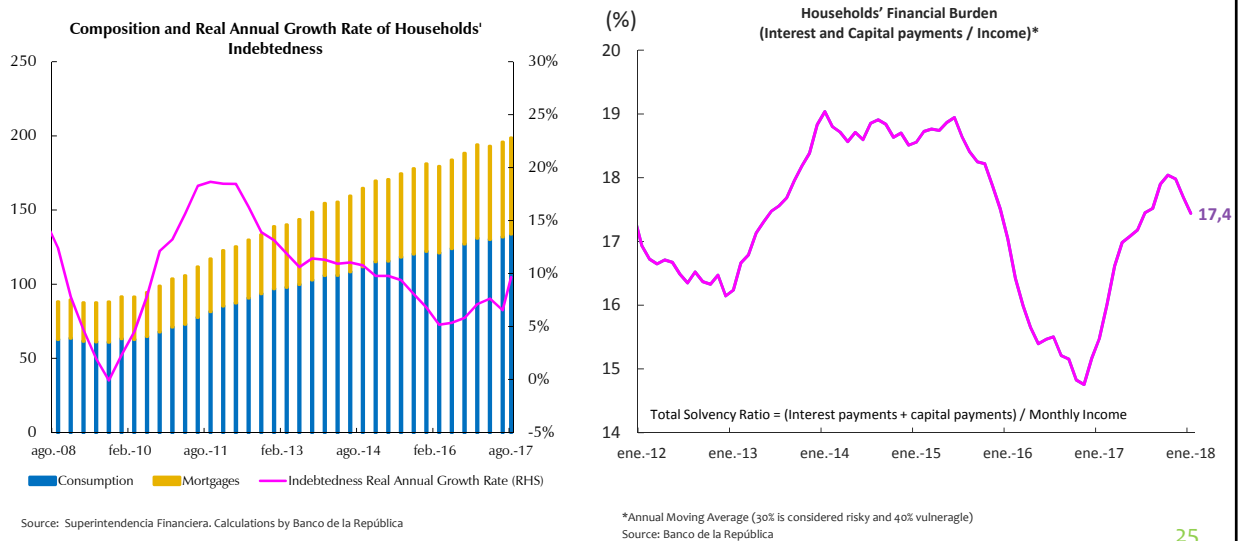
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- During the last years the interest rate and the devaluation of the exchange rate are the main factors that explain the growth of public debt.



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Debt levels have increased but remain below critical levels.



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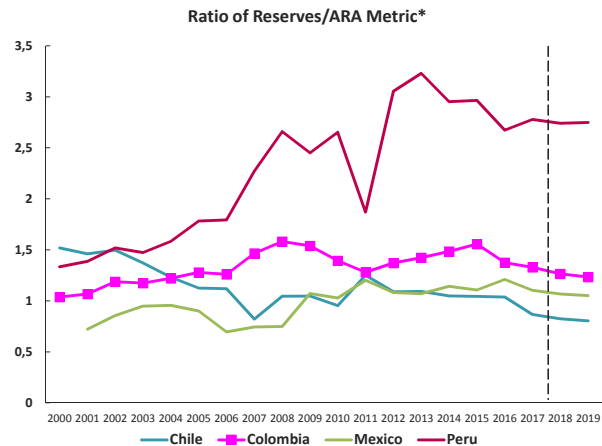
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A sufficient level of external buffers provides another safeguard against external shocks.

The Flexible Credit Line (FCL) by the IMF has complemented the accumulation of international reserves.



*A ratio between 1 and 1,5 is considered adequate
Source: IMF.



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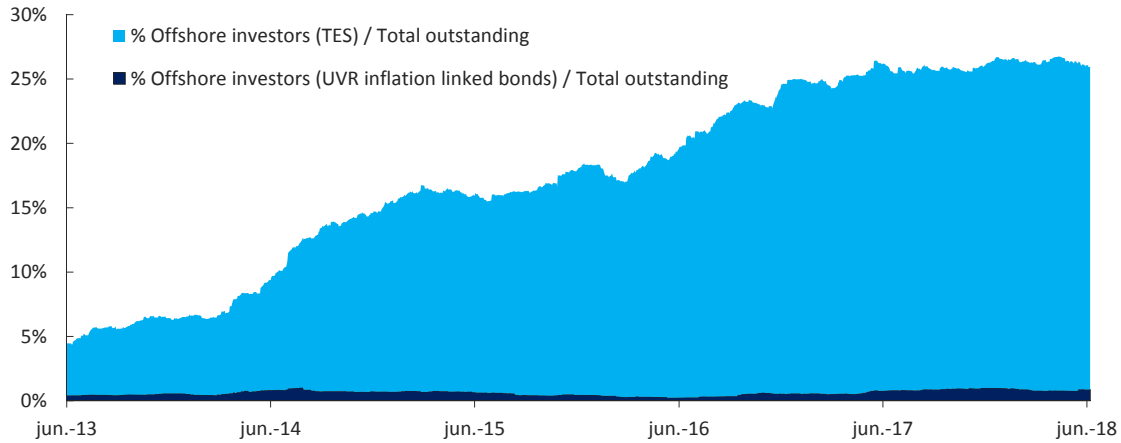
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The development of the **public debt market** came hand on hand with an increased **participation of foreign investors**, particularly in recent years. This increase was mainly driven by the **reduction of withholding tax** for offshore investors (from 33% to 14%) and the increase of Colombian debt weight in the **JP Morgan's GBI index** since 2014.

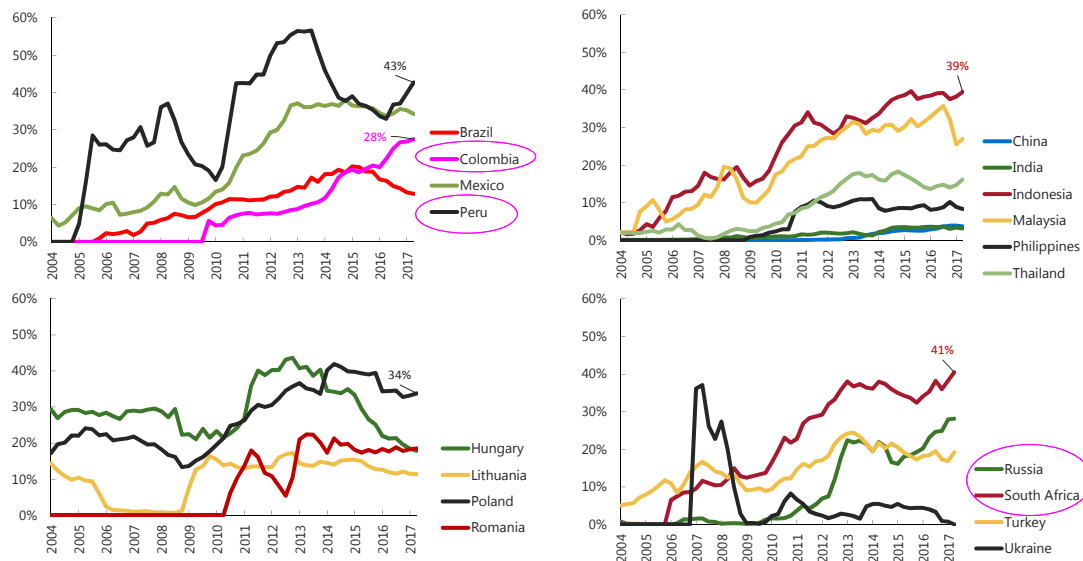


Source: Banco de la República

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The higher presence of offshore investors in Colombia goes in line with the experience of other emerging markets.

Foreign Holdings of Local-Currency EM Government Debt Securities (% of total)



Source: IMF WP - Arslanalp and Tsuda (2017)

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A Higher Participation of Non-Resident Investors in the Local Public Debt Market is Welcomed but Creates Challenges

- The increase in offshore participation has been positive for diversifying the Government's financing sources and has helped to finance the current account deficit **facilitating the adjustment of the economy to external shocks**. In addition, **the currency risk is assumed partially by foreign investors**.

BUT...

- Foreign investors' decisions could affect interest rates along the curve **offsetting in some cases the transmission of monetary policy to bonds with longer maturities**.
- A sudden exit of foreign investors could create **pressures on the exchange rate**. **A big reaction of these agents could amplify the effects of external shocks with possible implications on financial markets and financial stability**.

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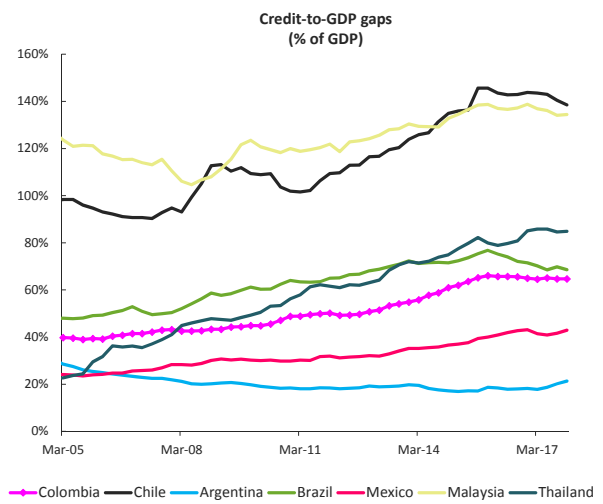
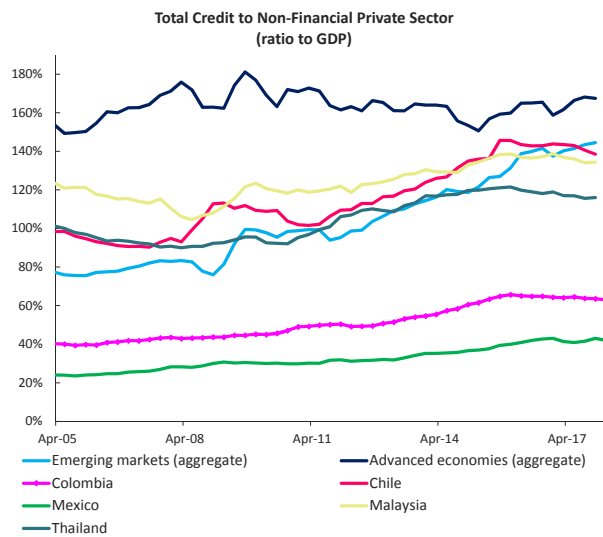
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Thanks

Debt levels in Colombia have increased in last years but the size of the credit expansion is below international averages. Financial depth is still low relative other EME.



Source: Bank for International Settlements

