The Inflation Targeting Strategy in Colombia

OBJECTIVES

Monetary policy in Colombia is based on inflation targeting, which is intended primarily to keep inflation low and to ensure stable long-term growth in output. Accordingly, the objectives of monetary policy combine the goal of price stability with maximum sustainable growth in output and employment. In this respect, monetary policy complies with the constitution and contributes to the well being of the Colombian population.

HORIZON AND IMPLEMENTATION

The Board of Directors of the Central Bank of Colombia (BDBR) sets quantitative inflation targets for the current year and the next. BDBR policy initiatives are designed to meet each year's target and to provide for long-term inflation at around 3%. The annual variation in the consumer price index (CPI) is the inflation measurement used.

THE DECISION-MAKING PROCESS

Monetary-policy decisions are based on an analysis of the current state of the economy and its prospects for the future, and on an assessment of the forecast for inflation in light of the targets. If the assessment suggests, with enough certainty, that inflation will deviate from its target under current monetary-policy conditions and the deviation would not be due to temporary shocks, the BDBR modifies its policy stance. For the most part, this is accomplished by changing the intervention interest rate (charged by the Central Bank of Colombia on short-term liquidity operations).

COMMUNICATION AND TRANSPARENCY

decisions on monetary policy are announced after meetings of the Board of Directors, through a press bulletin posted immediately on the Bank's website (www.banrep.gov.co). Inflation reports are published quarterly and lend transparency to the Board's decisions. They also contribute to a better understanding of monetary policy and help to enhance its credibility. Specifically, these reports i) let the public know how the Board of Directors and the Technical Governor of the Bank view recent and anticipated changes in inflation and its short and mid-term determinants; ii) explain the implications of those determinants for monetary-policy management within the scope of inflation targeting; iii) describe the context and analysis justifying monetary-policy decisions made during the quarter; and iv) provide information that helps economic agents to form their own expectations about future developments with respect to inflation and growth in output.

Assessment of Inflation and Policy Decisions

The first half of 2009 was characterized by falling annual inflation, largely because of the slowdown in food prices and, to a lesser extent, the sluggish pace of regulated price hikes. The core inflation indicators, which do not include the CPI items most sensitive to supply shocks, also exhibited a downward trend during that period.

By June 2009, the annual variation in CPI was 3.81%, which is below the target range for this year (between 4.5% and 5.5%), besides being 233 basis points (bp) less than the annual figure for inflation reported one quarter before and 386 bp less than annual inflation in the previous six-month period.

The sharp annual rise in food prices during 2008, which reached 13.2% in December, was reversed to 2.8% in June of this year, which explains 81% of the slowdown in inflation during the first half of 2009. The annual variation in regulated prices during the same period went from 9.5% to 5.9% and accounted for 17.3% of the reduction in inflation. By June 2009, the annual variation in non-tradables without food and regulated prices was 5.2%, which is 50 bp less than what it was in December.

Tradables without food and regulated prices constituted the only group to post an increase in annual inflation. Although the dollar price of imported goods declined during in the first half of 2009, annual depreciation in the Colombian peso surpassed that reduction and helped to raise annual inflation in this group from 2.4% to 2.8% during the same period.

In June 2009, the annual average of the four core inflation indicators calculated traditionally by the Central Bank of Colombia was 4.6%, which is 100 bp less than in December 2008.

As the first half of the year progressed and annual inflation slowed, expectations and forecasts for inflation suggested it would be below the target range by the end of the year. Accordingly, the latest forecast by the Central Bank's technical team indicates the annual variation in CPI at December 2009 will likely be less than 4%.

On the external front, the economic growth figures at March 2009 for the developed countries show a deepening of the recession observed since 2008. Most Latin American economies also experienced less annual growth in output during that quarter, as well as a pronounced drop in inflation accompanied by major annual reductions in the value of world exports, particularly of the industrial variety. Less external demand also contributed to the fact that international commodity prices were lower during the first half of 2009 compared to the average reported in 2008. However, they were similar to the level observed in mid-2007.

Therefore, the drop in the dollar value of traditional Colombian exports between January and May 2009 with respect to the same period the year before (-24.0%) is explained largely by less external demand and lower international prices. On the same dates, non-traditional exports also showed the effects of the trade restrictions imposed by Venezuela and Ecuador, having fallen by 10.3%. The decline in remittances, lower levels of foreign direct investment, and the deterioration in consumer and producer confidence are other channels through which the international crisis has been passed on.

The annual growth figures published by DANE for the first quarter of 2009 (-0.6%) confirmed the projected weakness in internal demand. The annual variation in household consumption was negative (-0.5%) for the first time since the same quarter in 2002. Government consumption rose at an annual rate of 0.2%, which is less than the average increase in 2008. Gross capital formation dropped 1.3% owing to less investment in transport equipment (-22.4%) and constructions and buildings (-14.8%). However, an even larger decline in investment was avoided, thanks to the annual increase in civil works (21.2%).

Although economic activity remains weak, available information for the second quarter shows business and consumer expectations point to signs of recover during the second half of the year. The financial system's performance remains healthy and lending continues to increase at a good pace, fueled largely by the commercial loan portfolio. Moreover, the decline in interest rates on loans to companies and families is expected to continue.

On the external front, several recent indicators of household and business expectations for the future of the economy in developed countries registered positive changes in tendency. The recovery of production in China and India, like the revival of exports in other Asian countries, provided an incentive to commodity purchases and to better capital market performance. The sharp depreciation in Latin American currencies at the start of 2009 was corrected in the context of a weakening dollar and less perception of risk with respect to the emerging countries. However, the negative effects of the world crisis are expected to continue throughout the year and growth in most countries is expected to be low, even less than long-term growth.

With the new data at hand, the Central Bank's technical team forecasts negative annual growth for the second quarter of 2009 and a recovery during the second half of this year. The estimated GDP growth range for all of 2009 is between -1% and 1%.

Monetary Policy Decisions

Monetary policy decisions were adopted in a scenario marked by the downward trend in inflation and growth. The Board of Directors of the Central Bank of Colombia (BDCB) gradually lowered the Bank's intervention interest rate by 550 bp to 4.5% by the end of June 2009. The cuts were made as follows:

- In December 2008 and January 2009, the rate was lowered by 50 bp at each meeting, ending at 9%.
- Between February and May, it was lowered again by 100 bp a month to the 5% level. In May, the BDCB announced that any eventual reduction in the future would be less than the recent cuts, based on the data at hand.
- At its June meeting, the BDCB agreed to a 50 bp reduction, which placed the rate at 4.5%. It also announced that, given the data at hand, it does not expect to make any further reductions in the intervention interest rate in near future.

The 550 bp cut in the intervention interest rate reflects an expansive monetary policy that encourages sustainable growth in an environment of low and stable inflation. The sharp increase in money, less of a hike in food and regulated prices, an external context that is not quite so negative, and the added momentum in civil works suggest a gradual recovery in economic growth as of the second half of the year.

The Board of Directors will continue to monitor the international situation carefully, along with the pattern and forecasts for inflation and growth. It reiterated that monetary policy in the future will depend on whatever information becomes available.

Board of Directors Central Bank of Colombia