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

Annual consumer inflation was up again in June 2008, having reached 7.18%. This is 125 basis points (bp) more than the rate observed the quarter before and 268 bp over the top of the target range for inflation this year (between 3.5% and 4.5%). As in recent months, the build-up in inflation during the second quarter was due primarily to the increase in food prices (11.98% in June), which accounted for 89% of total inflation.

Annual non-food inflation (4.90%), which climbed 23 bp during the second quarter, was responsible for the other 11% of the build-up in the total consumer price index (CPI). The momentum in this group was explained largely by higher prices for regulated goods and services, which went from an annual increase of 7.7% in March to 8.8% in June. The prices of non-tradables also contributed to the increase in inflation of this type, although less so, by rising 18 bp in the second quarter and ending June with a 12-month variation of 5.3%. Despite revaluation of the peso, the annual variation in the price of tradable goods, excluding food and regulated prices, declined by only 18 bp to 2.2%.

The three core inflation indicators published traditionally by the Central Bank of Colombia rose slowly but steadily in the last six months, averaging 5.05% in June (37 bp above the average reported last quarter). A fourth indicator, which is inflation excluding food and regulated prices, remained stable at a level slightly under 4%.

As a result of these rates, coupled with annual inflation during the first half of 2008 (6.0%), none of those surveyed quarterly by the Central Bank of Colombia believe the inflation target for 2008 will be met. Moreover, the different measurements of inflation expectations at one year remain high; in fact, they were above 5.5% towards mid-July. In the last three months, inflation expectations at five and ten years, derived from local government bonds, have increased from 4.7% and 4.4%, respectively, to 6.3% and 6.1%, in that order.

Production costs for companies are up. By June, producer inflation measured by the total producer price index (PPI) continued to climb and was 8.0%. The outcome for the last quarter reflects a sharp rise in local and imported raw material prices in the industrial sector. In June, inflation in imported raw materials emerged from negative terrain, where it had been for a year, while the PPI for produced and consumed commodities continued to growth at high rates (9.6%). As to wages, the available indicators show no uniform trend by sectors. While average wages in the construction sector had increased by June, registering high readjustments, the annual wage increases in industry and commerce remain stable at respective rates near 5.3% and 7.5%.

Average nominal interest rates on deposits and lending increased slightly in June to respective rates of 9.7% (DTF) and 17.1% (Central Bank's methodology). Even so, these are similar to the levels registered last April. In real terms, the average lending rate has declined since October 2007, interrupted only in April of this year, and is now below the historical average calculated since 1986. The decline in the real rate on ordinary loans is primarily responsible for this latest tendency; the lower real rate of interest on retail loans is also a factor, although not as much.

As to economic growth, the figures on the annual increase in gross domestic product (GDP) for the first quarter of this year (4.1%) showed a bit more of a slowdown than expected. This reduced momentum was the result of several factors related to both supply and demand, not all of which are easily quantified or necessarily generated by the change in the stance of monetary policy. The following are some of the reasons for this outcome, in addition to others that point to a slowdown in 2008:

- *A base of comparison that is high and possibly unsustainable in the long term.* The Colombian economy averaged 7% growth in the last three years, a figure not witnessed since the period from 1944 to 1946. A GDP increase like the one in 2007 (8.2%) is comparable only to those observed in 1978 (8.2%) and 1949 (8.7%). At times when growth has been this high, the increase in GDP for the coming year is very likely to be under its historic average.

- *Supply shocks.* To begin with, more holidays during the first quarter of 2008 meant less growth in sectors such as transport, industry and exports. The labor strike at Cerromatoso was a factor as well and prevented the company from operating throughout the month of March. Finally, as is customary in Colombia, the execution of public civil works is delayed when a new local administration takes office; this is because of the time it takes for mayors and governors to plan their infrastructure projects. Coupled with a high base of comparison established in the first quarter of 2007, this contributed to a 25% decline in civil works. If civil works are excluded from GDP, annual growth during the first quarter of 2008 comes to 5.1%.

- *The sharp rise in food and fuel prices.* This affects available household income, reduces spending on other goods and services and, therefore, slows total consumption. On the other hand, the increase in national and imported raw materials of agricultural, petroleum and other mining origin narrows company profit margins, discourages investment and, as a result, can end up generating higher prices now and in the future, in addition to less economic growth.

- *High consumption levels and a possible cutback in credit supply.* On this occasion, household debt (consumption, plus housing, as a percentage of GDP), which is similar to the levels registered in 1997, was concentrated in consumption. If the retail loan portfolio continues to deteriorate, the credit supply could tighten, which would affect the pace of household spending.

- Growth in foreign sales is expected to decline as a result of less demand worldwide, higher international interest rates and appreciation of the Colombian peso. The new figures for the United States suggest a less pronounced (but longer) slowdown in that country's economy, together with growing inflationary expectations. Accordingly, the United States Federal Reserve Bank (the Fed) is expected to raise its interest rate on at least one occasion during the second half of the year. The euro zone is expected to see less growth as well, accompanied by inflationary pressures. The European Central Bank has reacted to those pressures by raising its interest rates. As to the emerging economies, Venezuela, which is one of Colombia's most important trading partners, has experienced a sharp slowdown in economic growth this year, as well as sizeable increases in inflation. Given the growth in CPI and inflationary pressures in countries such as China, Chile, Peru, Brazil, Mexico and Turkey, the central banks in those countries raised their interest rates.

- Finally, the changes in monetary policy begun in April 2006 would be expected to help slow the increase in demand. This channel is necessary to reduce inflationary pressures and to achieve sustainable long-term growth.

In view of the foregoing and given the information available at June, the macroeconomic outlook can be described as follows:

- Economic growth in the first half of 2008 will probably be about half of what it was for all of 2007. This slowdown, which is more than was forecast, occurred from a higher level. In fact, the economic growth accumulated in the last three years was the highest witnessed in the past sixty years.

- High inflation, well above target for 2008, continues to influence agents' expectations of price growth in the near and intermediate future. This is coupled with virtually no confidence in the inflation target for this year.

- The forecasts for food and regulated price inflation exceed those estimated last quarter and could end up tainting other groups in the CPI basket. By the same token, the annual increase in some of the core inflation indicators has yet to slow.

- Further appreciation of the exchange rate might imply less of an increase in the prices of tradable goods. However, so far this year, peso appreciation has not been enough to offset the rise in international prices for raw materials, as reflected in the PPI.

- Real interest rates on lending and deposits have declined and are below their historic averages.

- The international context has deteriorated compared to last quarter. This situation is accompanied by favorable terms of trade and a world interest rate that is expected to be higher in the future.

In short, reduced prospects for growth this year in Colombia and worldwide suggest there will be no change in intervention interest rates. However, the increase in inflation, the outlook for inflation next year and the importance of tying expectations to a downward path for inflation indicate in the intervention interest rate should be raised. Low and stable inflation helps to maximize economic growth in the long run.

The Board of Directors adopted two monetary policy decisions in view of these circumstances.

- At a meeting in June, it decided to accumulate US$20 million daily in international reserves, as of the 20th of that month. The goal is to make the economy less vulnerable to external shocks and is being accomplished through direct purchase auctions. To offset the direct effects of that intervention, among other measures, the Board changed the bank reserve requirements by eliminating the marginal reserve and increasing the ordinary reserve.

- To anchor inflation expectations to the long-term targets and, particularly given the risk posed by the collateral effects of international food and fuel prices, the Board also agreed to raise the Central Bank's intervention rate from 9.75% to 10%. This decision was adopted at a meeting on July 25 of this year. The idea is to avoid having to take stronger action in the future in response to price and wage hikes that go beyond the targets set by the Central Bank.

The Board will continue to carefully monitor the international situation and the behavior and forecasts for inflation and growth. It reiterated that monetary policy in the future will depend on whatever new information becomes available.

Board of Directors
Central Bank of Colombia