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 dicisions

The annual variation in consumer prices (CPI) was 6.14% in March, which is 1.53 percentage points (pp) less than the increase reported at the end of 2008 (7.67%). This confirms the downward trend in inflation that began five months ago. The pattern of inflation during the quarter is explained by less of an adjustment in food prices, with fruits and vegetables being the only exception.

The non-food CPI also saw less of an annual increase during the same period, due to the slowdown in regulated prices. The other core inflation indicators declined, with the exception of the CPI excluding food and regulated prices, which has remained at around 4%. Consequently, the averages for the three core inflation indicators normally calculated by the Central Bank of Colombia declined. These measures do not include prices for goods and services that can be affected by temporary supply shocks; they include only those that can be affected by monetary-policy measures.

The annual variation in tradable prices, excluding food and regulated prices, rose slightly throughout the first quarter of this year. Factors such as devaluation in the price of the peso at the start of 2009 prevented the reduction in international prices for raw materials and other industrial goods from being fully passed through to local prices. However, the tendency in the exchange rate reversed during the past month.

In February and March 2009, the annual increase in prices for non-tradable goods and services, excluding food and regulated prices, stabilized at rates near 5.5%, which is the upper limit of the target range for inflation this year. These prices are closely related to the trend in local demand. The inflation inertia observed in this basket of goods and services is explained largely by the way highly indexed prices performed, such as those for education, health care and, to a lesser extent, rentals.

The reduction in inflation during the quarter was accompanied by external and internal factors that have helped to relieve inflationary pressure. The following are the details with respect to those factors:

- On the external front, the new figures for the financial system in the United States bolstered confidence on the securities market, raising the stock market indexes. However, the forecasts for 2009 announced by leading international organizations such as the International Monetary Fund (IMF) indicate that economic growth in the United States will be negative (-2.6%) and job creation will be extremely weak. The outlook for the European economies is no better and the expectation is for a slow recovery that would begin to take shape in the final quarter of this year. In Latin America, the generalized contraction in industrial production and the drop in inflation are a reality.

- The world economy and world trade suffered a dramatic setback during the first quarter of 2009, in addition to the drop experienced during the fourth quarter of last year. These results largely confirm the fears of a sharp recession in the global economy. The range of real external indicators points to more of a decline than was envisioned in the last edition of this report. The external market for Colombian products continues to weaken and remittances from Colombian migrants keep losing momentum.

- On the internal front, after the peak in 2007, the increase in internal demand and economic growth declined during the first three quarters of 2008 to respective average annual rates of 4.4% and 3.6%. During the final quarter of 2008, these same variables slowed dramatically to 1% and -0.7%, which is less than the Central Bank and the market expected. Accordingly, GDP growth was 2.5% in 2008, which is a third of the rate observed in 2007.

- The available indicators on supply and demand show the first quarter of 2009 may have seen negative economic growth similar to what was observed at the end of 2008. They also confirm the output gap is in negative terrain and no demand-pulled pressures are anticipated for this year.

- According to the monthly and quarterly surveys conducted by the Central Bank of Colombia, inflation expectations continue to fall. Analysts' one-year ahead forecast for CPI growth, coupled with the longer term expectations for inflation implicit in the government's debt, show rates below the midpoint of the 2009 target range.

- Non-labor costs continued to decline during the first quarter of 2009, as suggested by the pattern in the producer price index (PPI). According to that indicator, annual producer inflation was 6.8%, which is 2.2 pp less than in December. The decline in international oil prices and the government's decision to lower gasoline and diesel prices as of May will permit lower costs for transport and other items that affect the CPI.

- The wage hikes reflected by the sector indicators available in February show declining increases. In the case of employees covered by collective bargaining agreements, their wage adjustments remain pegged to the annual variation in the CPI. The result was higher increases for this group of employees compared to the adjustments registered in 2008. The rise in the minimum wage led to a similar situation.

- Labor supply measured by the global participation rate (GPR) increased between December 2008 and February of this year. Because the rate of growth in that variable exceeded the increase in employment, the net result has been a higher unemployment compared to the same period last year.

- The broad monetary aggregate (M3) has lost momentum, after reflecting an upward tendency in its annual variation between November 2008 and February of this year. Even so, the annual growth rate for this aggregate is still well above the nominal increase in GDP estimated for 2009.

- So far this year, the balance of funding use and sources for institutions in the banking system shows the priority is on investments and, to a lesser degree, on credit. The slowdown in growth in the portfolio denominated in domestic currency continued until mid-February, but was less pronounced in March and early April. In real terms, the increase in the portfolio exceeds the historic average calculated since 1971, primarily because of the way the commercial loan portfolio performed. On the other hand, consumer lending continued to lose momentum.

- Unlike the situation in the developed countries, lending institutions in Colombia are solid. This is crucial if the credit channel is to operate as it should. In fact, the sector has capital adequacy indicators above the regulatory levels and continues to register important profits.

- The drop in interest rates on savings and lending shows the cut in the Central Bank's benchmark rate was passed through quickly to the market. The pattern in the non-food CPI also helped to lower those rates, in real terms, to levels near the average calculated since 2001.

In view of the foregoing, the interest rate reduction policy initiated by the Board of Directors of the Central Bank of Colombia in December 2008 was maintained between February and April 2009. During that three-month period, the reduction amounted to 100 basis points (bp) per month, inasmuch as inflation expectations were declining and within the target range, accompanied by less-than-potential economic growth. Given this scenario, demand and future economic growth can be supported without compromising the inflation target. Accordingly, in April 2009, the benchmark rate was set at 6%, which is 300 bp less than in January 2009.

The Board will continue to monitor the international situation carefully, along with the forecasts for inflation and growth. It reiterated that monetary policy in the future will depend on the new figures that become available.

Board of Directors, Banco de la República (Central Bank of Colombia)