The Inflation Targeting Strategy in Colombia

Objectives

Monetary policy in Colombia is based on inflation targeting, which is intended first and foremost to keep inflation low and to ensure stable long-term growth in output. Therefore, monetary policy objectives 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 Banco de la República (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 compared to the targets. If the assessment suggests, with enough certainty, that inflation will deviate from its target under current monetary-policy conditions, and that the deviation would not be due to temporary shocks, the BDBR modifies its policy stance. This is done primarily by changing the intervention interest rate (charged by Banco de la República on short-term liquidity operations).

Communication and Transparency

Decisions on monetary policy are made at meetings of the Board of Directors and announced immediately thereafter in a press bulletin posted 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 enhance its credibility. Specifically, they 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 medium-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 declined from its high point in 2007 for the fifth month in a row. The rate in September (5.01%) was 102 basis points (bp) less than during the previous quarter and 125 bp below the rate in April, when inflation was the highest so far this year. During the quarter, the average of the three traditional core inflation indicators declined by 35 bp to 4.75%.

The slowdown in food price increases explains most of the reduction in inflation. Less inflation in regulated prices and tradables also was a contributing factor, but not as much.

The reduction in food supply due to El Niño weather caused food prices to rise sharply during the first five months of 2007. However, this trend reversed in the third quarter, when food inflation dropped sharply. Although predicted in earlier reports, both the increase and subsequent drop in food prices were more than estimated. In fact, annual food inflation peaked in May 2007 (10.0%), then declined steadily until September (6.96%).

Regulated price inflation in September (5.96%) was down by 149 bp in the third quarter, thanks to lower rate hikes for public utilities. Inflation in tradable goods, excluding food and regulated prices, went from the high point in April 2007 (2.10%) to 1.19% in September (57 bp below the rate in June). However, the reaction of this last basket to accumulated peso appreciation during the last twelve months remains limited (11.7%).

Annual non-tradable inflation, excluding food and regulated prices, continued on the upward course initiated a year ago. Its annual growth rose by 43 bp in the third quarter to 5.55%, a level similar to the forecast in the June report. However, this indicator was stable between August and September 2007.

For the most part, the decline in inflation during the third quarter of 2007 surpassed the forecast in the previous report and what the market expected, on average, according to the quarterly survey conducted in June by Banco de la República. The accumulated increase in the benchmark interest rate (325 bp), coupled with the other monetary-policy measures that accompanied these hikes, are having an effect and will help to curb price growth next year.

However, some of the inflation pressure sparked by the momentum in local demand persists. At the same time, other external factors have emerged that could influence our economic growth and the price level next year. These events, which are described in this report, add to the uncertainty surrounding the forecasts for inflation and economic growth in 2008. The following summarizes how the major determinants of inflation are expected to perform in the coming quarters.

1. With the exception of tradables, excluding food and regulated prices, the other CPI classifications continued to register annual inflation above the target range for 2007. Coupled with the likelihood that this year's inflation target will not be met, this could generate inertia in inflation expectations and affect the development of prices and wages in 2008. Moreover, both the quarterly and monthly surveys done by economic analysts show they still expect inflation in 2008 to exceed the target range for 2007.

2. Prices for commodities such as oil, soybeans and other farm products used to produce bio-fuels continue to rise. This has a positive impact on the economies of many of our trading partners (Venezuela, México, Brazil, etc.), but can cause additional inflation pressure in Colombia.

3. The pass-through of peso appreciation to inflation in tradable goods and services has been limited and could weaken if the exchange market becomes more volatile. In this respect, it is important to remember that the peso/dollar exchange rate, of late, has been among the most instable in the region and that preliminary forecasts point to an increase in the current account deficit during 2008.

4. According to the economic indicators, the growth in aggregate demand likely will remain high. Household consumption, which rose by nearly 8% during the second half of the year, could maintain its momentum. This is indicated by the opinion polls, consumer loan portfolio growth, and the substantial increase in household imports. Accordingly, there is still the risk that the increase in local demand will be slower than expected to return to rates that are consistent with keeping inflation on target.

5. At June 2007, the indicator of financial depth, measured as the quotient between the loan portfolio and GDP, shows retail and commercial loan rates have surpassed their historic highs, while the level of the mortgage portfolio remains low. Although the gross loan portfolio increased less during the third quarter of 2007, it continues to grow at rates above the increase in nominal GDP. The build-up in credit helps to keep growth in aggregate demand high, but also reinforces the ability of monetary policy to influence household and company decisions on spending.

6. The increase in interest rates on lending and deposits during the third quarter of 2007 shows pass-through to the credit channel has gained speed. In September, real interest rates on deposits (known in Spanish by the acronym DTF) and those on commercial, preferential and treasury

loans were similar or slightly above their historic average. However, they continue to rise, partly because the usury rate is up, and are likely to exceed that average in October.

7. A solution to the mortgage market crisis in the United States could be slower in coming, which means it would have more of an impact on world economic growth than anticipated initially. In that case, our trading partners might experience less growth, which would exert downward pressure on our export products. Aggregate demand in the Colombian economy could decline as a result and the peso would tend to depreciate. This last effect would be even greater if changes on the international scene reduce the flow of capital into Colombia.

In view of the foregoing, the Board of Directors decided, at a meeting in August 2007, to hold off on further hikes in the Bank's benchmark interest rate until more is known about how the volatility on international markets could affect the Colombian economy and the impact monetary policy could have on aggregate demand and prospects for inflation.

Board of Directors
Banco de la República