

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 annual variation in consumer prices so far this year has surpassed the target range set for inflation in 2008 (between 3.5% and 4.5%). Most of this increase is the result of supply shocks to the economy, such as severe changes in climate and rainfall, coupled with soaring international prices for oil and agricultural raw materials. Nevertheless and despite far less growth in internal demand (particularly as of the second quarter of 2008), the average for the various core inflation indicators shows no clear signs of easing. This could be due to more pronounced inflation inertia as a consequence of the international price shock.

Annual inflation at September was 7.57%, having declined slightly compared to the year's high point in August (7.87%). The downturn stemmed from the reduction in food inflation, which went from an annual increase of 14.2% at August to 12.8% at September.

The annual increase in the non-food consumer prices index (CPI) has been slow but steady throughout the year, and was 5.2% by September 2008. Regulated price inflation also increased, but more so, and was 10.5% by the third quarter. During the same period, tradable and non-tradable inflation without food and regulated prices came to 2.2% and 5.1%, respectively. The average of the three core inflation indicators published by the Central Bank of Colombia rose again in September 2008 to 5.9%, having been 5.6% the quarter before.

These figures helped to place inflation expectations at twelve months above the 2008 target range for inflation. In fact, inflation expectations generated on the basis of TES interest rates, as well as the two surveys conducted by the Central Bank, place inflation at above 5.3% in October 2009. This last figure also includes inflation expectations for a longer term (five years) based on government paper.

Regarding companies costs continued to increase during the third quarter of 2008. To begin with, the producer price index (PPI) rose again and was 9.8% in September. Based on the origin of goods, upward pressure was observed in the produced and consumed component, and in the imported component. As for the

different branches of economic activity, the PPI increase is largely explained by the build-up in the industrial PPI (7.2%). Secondly, the wage indicators that are available show stability in the pace of wage hikes, even though the rates of increase are higher than the inflation target for this year. The figures for August show nominal wages in industry and commerce rose by about 6%, while the variation in construction wages was close to 7% by September.

As noted in the last edition of this report, the slowdown in economic activity in Colombia during 2008 is the result of several supply and demand shocks that are difficult to quantify. The most relevant ones were the high base of comparison represented by GDP growth in 2007, which probably was not sustainable in the long term; the restrictions on trade with Venezuela; the Central Bank's active monetary policy; and local government delay in making public investments, given the change in mayors and governors. Moreover, higher prices for food and fuel reduced the purchasing power of agents in the economy and raised production costs for companies, thereby affecting economic growth.

Consequently, the average annual increases in GDP for the first and second quarters of 2008 (4.5% and 3.7%, respectively) continue to reflect an important major slowdown compared to high average growth during the last two years (7.3%).

The drop in internal demand was the factor that contributed the most to the decline in economic growth between the first and second quarters. The slowdown in household consumption (from 3.4% to 3.1%), as well as less investment in civil works (which went from -14.6% to -13.8%), explain the bulk of this situation. Investment without civil works was the most dynamic component of internal demand (17%). Real exports and imports in pesos slowed, but continued to grow at a good rate during the second quarter (at around 10%).

On the external front, the international macroeconomic situation continued to weaken more than expected, particularly as of mid-September when Lehman Brothers went bankrupt. Therefore, the primary concerns remain focused on the financial crisis and the recession that already is evident in the United States, its spread to the world's more prosperous economies, the increase in international restrictions on credit and the negative impact it could have on economic activity the world over. Up to now, the recovery plans adopted by economic authorities in the United States and Europe to recapitalize leading international financial institutions with public funds and to put liquidity into the system, have yet to succeed in fully re-establishing credit channels and in lowering the cost of borrowing.

The negative prospects for world growth, which were accentuated at the end of the third quarter, pushed down international prices for oil and other commodities, following a substantial rise up to mid-July. The world security markets experienced sharp price declines, and the currencies of the developing countries sharply lost value against the dollar. Colombia was no stranger to

these situations. Consequently, lower terms of trade, a weaker world economy, restrictions on international lending and the higher cost of external financing are the factors that may have a significant impact on economic activity in the emerging countries, including Colombia.

In view of the macroeconomic context described above, the Board of Directors of the Central Bank of Colombia (BDBR) raised the Bank's benchmark rate from 9.75% to 10% at their meeting on July 25th. However, in August, September and October, it was considered prudent to leave it unchanged. Nonetheless, a press bulletin on the most recent meeting warned that "weak demand and the recent drop in international prices should spell less inflationary pressure in the future. To the extent that mid-term inflationary pressures continue to abate, it would be appropriate to consider moving towards a less restrictive monetary stance."

Furthermore, given the international turbulence, the Board of Directors decided to eliminate the deposit on external borrowing, effective as of October the 9th. And, at a BDBR's meeting on October the 24th, the following measures were adopted to supply liquidity in order to facilitate operation of the monetary and loan markets to facilitate the operation of monetary loan markets:

To reduce bank's reserve requirements from 11.5% to 11% for current and savings accounts, and a reduction from 6% to 4.5% for term deposits under 18 months. These cuts will take effect as of the two-week reserve maintenance period scheduled to begin on November 19. The measure is expected to free up nearly one trillion pesos by December.

To extend from two to three weeks in the reserve calculation for the end of the year.

To provide temporary liquidity provided through 14 and 30-day repo operations, in amounts to be announced in due course.

The definitive purchase of Col\$ 500 billion in TES, plus the peso equivalent of the sale of foreign exchange through the call option system.

The reverse-repo auctions through remunerated deposits not constituent of requirements will be closed temporarily. The Lombard contraction window will be left open.

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

Board of Directors, Central Bank of Colombia.