Colombia´s passage through the current world crisis

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Growth is expected to slow down everywhere in 2009 and Colombia is not going to be immune from what is going on in the rest of the world. In this speech I outline the main reasons why despite this I think our growth will remain positive in 2009, even in per capita terms, and we could be in a good position to benefit from a global recovery in 2010.

But much still depends on how we avoid the risks that await us in the year ahead. So I also want to try to make clear to you that the main risk is on inflation.

The ultimate goal of macroeconomic policy is Colombia should be to provide a firm foundation for sustainable growth in the face of swings and cycles in the world economy. Therefore what ever actions our policymakers take in response to the lower growth should at the very least not damage our chances of sustainable growth in 2010 and beyond. If we keep to this reasoning, then we could be in a good position to benefit from a global recovery in 2010.

World economy

As the November 2008 IMF forecast update makes clear, countries all over the world are likely to grow slowly in 2009. The advanced nations are expected to fare the worst, with output in the United States, Europe and Japan all actually expected to shrink. Growth in non-Japan Asia is likely to be a few percentage points less than in previous years. Even China's growth is forecast by some analysts to fall close to 6%. Here in Latin America, growth will on average be about half what it was in the last two years. This all might seem gloomy. But their forecast is also for a recovery even as soon as at the end of 2009, when the massive policy actions of the last year and a half begin to work through to unshackle bank lending.

What does the world slowdown mean for Colombia?

A world slowdown will mean less demand for our exports. Colombia's exports are over 20% of GDP. Then a slowdown in world demand by say 2 percentage points between 2008 and 2009 is likely to lower our growth by between a half and one percentage point[2]. So the slowdown in world growth will have an important effect on Colombia. But it won't be as large for other countries which are more open, at least not through this channel.

But on top of this, commodity prices have fallen in world markets over the last six months. This matters because our exports remain quite concentrated in commodities: petrol and derivatives, coal, coffee and ferronickel exports sum up to about 10% of GDP. Naturally if

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[2] The effect would be larger, the greater the income elasticity of demand for our exports. On the other hand, it may be lower if some of our exporters, for example of industrial products, are able to switch to domestic markets.

world prices fall, the dollar earnings of these exporters will be cut back. While it is true that we also import commodities, such as foodstuffs and raw materials, historically our business cycle is positively correlated with the cycle in world prices, and so we should expect the effect of lower export prices to dominate.

That said our export prices rose so much since 2000 that even the very sharp falls last six months of have left export prices at levels with which we could be comfortable with. For example the oil price is now around 30 dollars a barrel. Although this is low, and should be measured in real terms, we should remember that the average price for 1980 to 2000 was 22 dollars a barrel[3].

This then leaves possibly the most important channel through which the current global crisis may come to affect us, which is through capital inflows. Colombia is a net debtor and so needs external funds. As financial institutions elsewhere seek to recapitalize and improve their balance sheets they might become reluctant to lend to emerging market countries and may even want to retire outstanding commitments. So we have been expecting restrictions on our international borrowing as an inevitable consequence of this crisis.

But even here, there are reasons to be relatively optimistic:

First, it should matter that capital inflows into Colombia are increasingly of the form of Foreign Direct Investment. By its very nature foreign direct investment is over a longer term and so we know that in 2009, we will still receive funds for important projects. A reasonable projection would be that FDI flows into Colombia fall from the 10 billion dollars of 2008, which is about of 4.2% of GDP, to 7 billion dollars in 2009, which is still about 3.4% of GDP.

Second, relatedly, judged on criteria such as the current account deficit, or the level of foreign exchange reserves, Colombia's external position looks more sustainable going into this crisis than previous episodes. One can argue, and with good grounds, that we should have done more, given just how favourable the last few years have been. But the point still stands that we do not have any signs of vulnerability flashing red.

And thirdly, and perhaps most importantly, we have improved the way in which we manage capital inflows within our financial system. A big lesson about the sustainability of capital inflows that we are all relearning now is that much depends on how we deal with those inflows in the domestic financial system.

This last point deserves more explanation. Let me go back to the effect of lower export prices on our growth. Before we leap to the conclusion that lower commodity prices always mean much slower growth in Colombia, we should stop and think how, exactly?

The simple answer might be that export prices matter through export sectors' GDP. But that answer would be wrong. Charts A.1 to A.3 show that lower export prices are not associated

[3] WTI oil price per barrel.

with lower real GDP in agriculture, mining or industry. The reason is that it takes time for export sector production to respond to the higher export price. Instead as Charts A.4 to A.6 show, it is the big nontradable sectors' GDP that is the procyclical driver of the domestic economy's response to real export prices.

These paradoxical sectoral responses were recently studied by two of my staff members, Lavan Mahadeva and Javier Gómez. They seem to come about because strong financial inflows are also associated with the higher export prices. It seems that when our export prices are high, our capital inflows are also strong. With their deposits swollen, domestic banks lend out credit to those consumers and investors who do not have direct access to the international financial market. That spurs growth in the non-tradable sectors to which much of the extra spending is directed. When international financial flows dry up, domestic banks find that less funds available to them, and start to tighten domestic credit and the cycle goes into reverse. This story brings the procyclical nature of the financial sector to the fore.

Smoothing out this cycle is a job for all our macroeconomic policies. One reason is that as much of domestic consumption is directed at nontradables, and as the relative prices of nontradables is the real exchange rate, the higher export prices and strong inflows cause strong appreciations during booms. This constrains the standard monetary policy instrument of interest rates, if that is left to act alone. If we could contain the boom in non-tradable spending by supportive financial stability and fiscal policy actions, we would have less of an appreciation, and also less of a recession when the global growth cycle goes into reverse.

In summary the stop-start nature of the global cycle calls for countercyclical domestic policy acting along the dimensions of financial stability, monetary and fiscal policy. The point is that if Colombia is to make good use of international financial markets, we have to lean against these international forces and not let any booms in our domestic financial sector get out of hand. In the next section, I will explain to you what progress we have made along these lines in recent years, which gives me some grounds for optimism for 2009.

The Colombian financial system going into this financial crisis

Let me put my analysis of the last section into context by telling you about our experience during this recent global boom.

In 2004 and 2005, the Colombian economy had just finished recovering from the long and deep recession that we fell into following the Asian and Russian crises. But by early 2006, that recovery was very quickly transforming into a boom. Inflation was picking up, and domestic demand was growing much faster than GDP. The current account deficit was widening even as our terms of trade were improving. These were supported by strong export prices and inflows of capital. Just as I described, a favourable global cycle stimulated our banking sector to lend domestically. There was a sudden burst of credit growth in the second half of 2006, which brought in new, more risky borrowers into the credit system and weakened the balance sheets of our firms and households.

This can be judged not least from the sheer speed at which some of these phenomena were occurring. For example, financial system loans' real annual growth went from 10% in December 2005 to 27% in December 2006. Average core CPI annual inflation increased from 3.5% in April 2006 to 4.8% in April 2007. The current account deficit widened from 1.8% of GDP in the second half of 2006 to 3.6% of GDP in the first half of 2007.

We responded by raising interest rates. In all, we put up interest rates by 400 basis points between April 2006 and July 2008.

Yet demand and credit were expanding so quickly, that just was not enough. Also, the authorities were concerned about the appearance or deterioration of currency mismatches in the private and public sectors´ balance sheets, a lesson painfully learnt in the late nineteen nineties.

So, in addition to the central bank interest rate increases, in 2007, we raised marginal reserve requirements to slow down the flow of bank credit. On top of this, our financial stability authority raised banks its required provisions for credit and implemented a new system of administering credit risk.

We also stepped our accumulating international reserves during this up-phase, and in 2007, we imposed measures to make it more costly to borrow short-term from abroad, as well as to limit currency mismatches and foreign currency liquidity risk. More specifically:

- We already had limits on the net foreign currency- denominated asset position of Banks and other financial institutions as a fraction of their net worth. These limits are meant to curb currency mismatches of financial intermediaries.

- We require Banks and other financial institutions to have a positive net "cash" foreign currency-denominated asset position of as a fraction of their net worth. This ensures that foreign currency liquid assets exceed liquid foreign currency liabilities, thus reducing the foreign currency liquidity risk of the financial system. There is also an upper bound for the net "cash" foreign currency-denominated asset position to avoid excessive pressure on the exchange rate in episodes of rapid depreciation.

- We reactivated a deposit requirement on foreign debt and portfolio investment in order to discourage short-term capital inflows and reduce the vulnerability of the economy in the face of a sudden reversal of those flows.

- We imposed a limit on the gross foreign exchange derivative position of Banks and other financial institutions as a fraction of their net worth. This limit was aimed at reducing the counterparty risk of financial intermediaries in the FX derivative market.

These measures have paid off. We are in a better position as we go into this crisis. Our domestic demand growth has cooled. The growth rate for the first half of 2008 is 4.9% above the same six months of 2007. In conjunction, our current account deficit has stopped widening. Real credit growth for our financial sector as a whole has slowed from over 20%

to healthier rates around 13%. Our financial system has a 13.9% risk weighted capital ratio, well above the Basle II minimum recommendation. Banks have expanded their provisions substantially, following the new legislation. International reserves are now equivalent to about 35% of the deposits in our financial system.

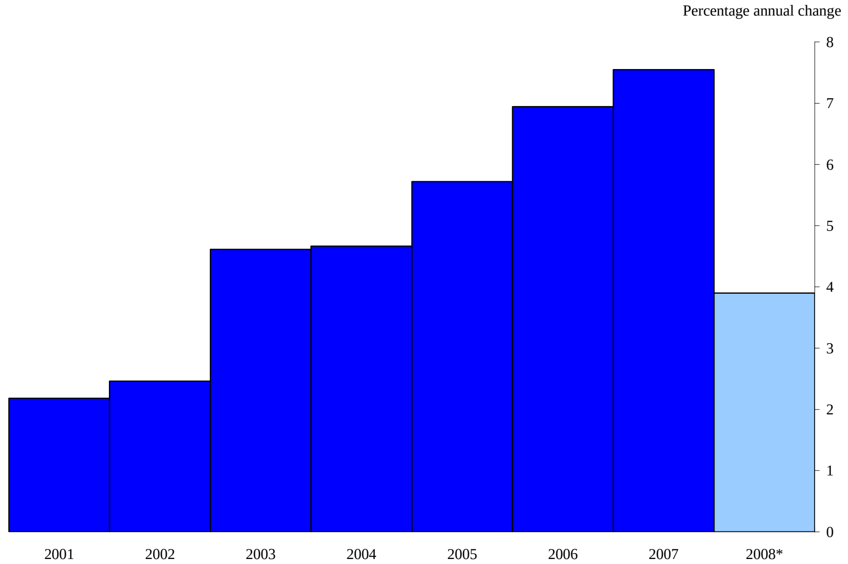
The above-mentioned foreign exchange regulations restricted the foreign currency intermediation activities of local banks and prevented the development of a foreign currency loan interbank market. At the same time, those regulations limited short-term foreign currency indebtedness and currency mismatches of the private sector, as well as its scope to hold large foreign exchange speculative positions. As a result, the foreign currency liquidity risk was largely contained in Colombia.

GDP growth in 2008 and our expectations for 2009.

I want to now build on this to tell you about our GDP growth in 2008 and then from that starting point, look forward into 2009.

Chart 1 shows that our growth in 2008 is likely to be much less than what it was in 2007. In each quarter of 2008, growth has been less than the previous quarter and we expect to end up with an annual growth rate of 3.2% compared to 7.5% for 2007. One might think that this is exclusively due to the world slowdown, but domestic and regional factors played a great part during the first half of the year.

Chart 1. Real GDP Growth.

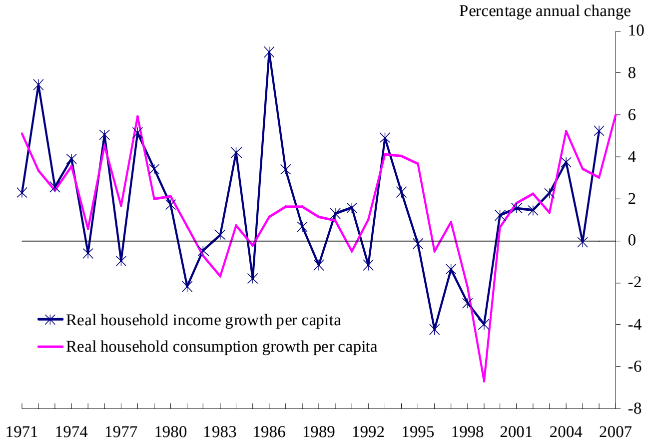


Note: 2008* is the rate of increase of the first three quarters of 2008 against the same three quarters of 2007.
Source: DANE.

Certainly some of the slowdown is due to our monetary policy actions. As I explained in the first section, we felt that it was important both for inflation and for the sustainability of growth not to let non-tradable spending get too far out of control during booms.

And then another very important factor that has cut down our growth was the drag caused by price shocks themselves. The sharp rises in prices that we experienced in this up phase began to weigh heavily on the real incomes of consumers by 2008. In countries such as Colombia where access to the financial sector is limited, consumption follows real income closely. See Chart 2.

Chart 2. Real Household Consumption and Real Household Disposable Income 1970-2007



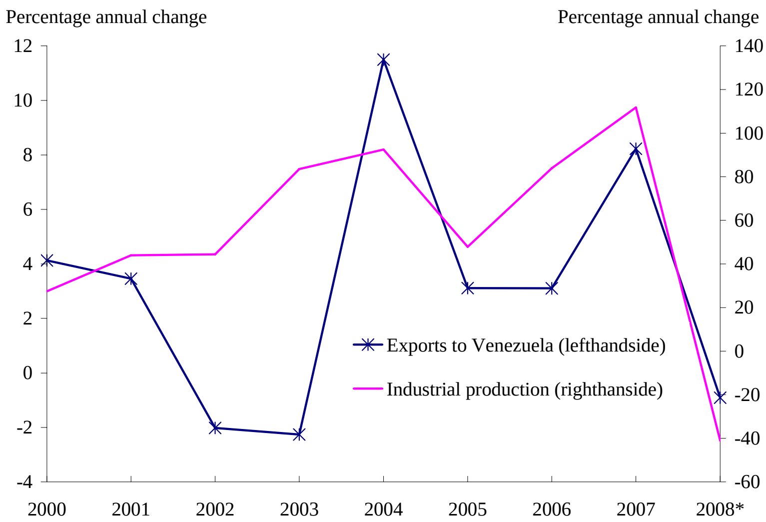
Source: DANE.
Real household income is nominal household income deflated by CPI.

In a similar fashion, the increases in oil and raw material prices have raised costs for our producers, holding back their output.

In this sense, some of this sharp slowdown in real income was unavoidable as it was driven by a one-off upward adjustment in relative food and energy prices at a global level. But there is still a responsibility for the central bank and that is to make sure that this relative price adjustment is not allowed to spread to a generalized and unruly inflation.

Another factor that explained the lower growth was restrictions to our exports to Venezuela that were imposed in March 2008. Venezuela is a major destination for our industrial exports, and has been a very lucrative market in recent years. For example about 80% of our automotive exports went there in 2007. Naturally then our industrial output growth was severely affected by these restrictions. See Chart 3.

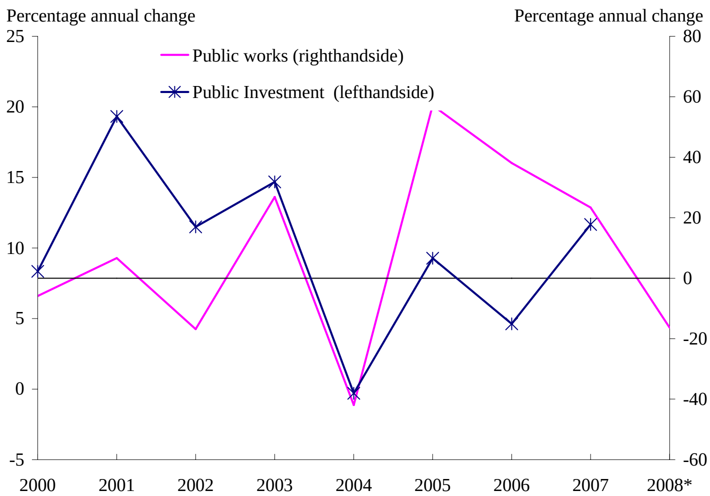
Chart 3. Colombian Industrial Production and Colombian Exports to Venezuela.



Note: 2008* is the rate of increase of the first three quarters of 2008 against the same three quarters of 2007.
Exports to Venezuela are in millions of dollars, deflated by U. S. CPI.
Source: DANE, Banco de la República and Economic and Labor Market Information Bureau.

In addition, there was the effect of the municipal elections of 2007. The new officials take time to appropriate the reins from the predecessors and so investment in public works fell sharply in 2008. Chart 4 shows just by how much and why we think this will be reflected in public investment data for 2008 when that it is published. That this is a special factor is shown by the fact that data on private investment for 2008 shows that this larger component has continued to grow at double digit rates, as has been the case for the last five years and which has taken the total investment rate close to 28% of GDP.

Chart 4. Public Works Growth and Real Public Investment.



Note: 2008* is the rate of increase of the first quarters of 2008 against the same three quarters of 2007.
Source: DANE.

Finally, as the international crisis deepened, the confidence of consumers and businesses in Colombia was shaken, and this also affected domestic spending.

Taken together, this deeper understanding of what happened to growth in 2008, gives us some further grounds for guarded optimism in 2009 even in the face of a worsening world environment.

First our consumers have already begun to sort out their balance sheets well in advance of any restriction in credit that might happen in 2009. Second, hopefully with lower growth and less excess demand, inflation in Colombia should fall back to towards our target in the near future. This should boost real income growth and thus should provide a floor for consumption growth. Public investment can recover from now onwards onto 2009 providing a countercyclical force against the slowing world cycle. Although our internal credit growth has fallen significantly, it continues growing at rates above nominal GDP growth, especially to the corporate sector and within that to construction firms.

It should help also that the monetary policy committee of the Banco de la República have been able to loosen monetary policy to an important extent since last summer. We have allowed a peso depreciation of just over 10% over 2008. In November, we reduced reserve requirements faced by our banking sector and eliminated some controls on capital inflows. And in our meeting in December, we cut interest rates by 50 basis points. Yet it as important in protecting growth in 2009 that we raised interest rates, and tightened policy through other means, from 2006 to early 2008. It is more the countercyclical nature of policy rather than any excessive loosening now that will keep our growth sustainable in the face of these shocks.

In summary, 2009 will be without a doubt a year of low growth for our economy. We could expect growth to fall somewhere in the range of 1.5 to 3%. Given the extent of the world slowdown, this is inevitable. But as I think we are in a relatively favourable situation, we do not expect growth to be too low nor for the slowdown to last too long.

Inflation in 2008 and 2009

One of the most important risks to this relatively favourable scenario is in terms of higher inflation, and so let me say a few words about what is happening to inflation.

In the last two years, Colombian inflation rose initially because of strong demand and then as a consequence of food and energy price shocks. It finished 2008 at 7.7 %. An important part of this inflation is due to supply-side shocks in food and fuel, and so we cannot try to make inflation fall back down towards lower levels immediately. For that reason we announced a target range of 4.5 to 5.5% for 2009 but also the range of 3.5% for 4.5% for 2010. This is a strong signal that we will not allow inflation to settle at the high level it is now.

Of course, there are reasons to expect that inflation will start to fall back down.

We can begin with consumer tradable goods. The rise in this component's inflation rate over the last two years happened despite four consecutive years of strong appreciation. This shows just how much world prices for these goods picked up, and how much importers' margins rose too. Those forces should now hopefully go into reverse. The world prices of these goods have fallen back sharply since the summer of 2008. Domestic demand has slowed down, and that should push down on importers' margins. Although our exchange rate depreciated in the second half of 2008, we can expect that to be relatively stable in 2009, making the prospect lower tradable inflation more likely. In particular we expect stable gasoline prices within Colombia for 2009. So we would expect imported price inflation to fall back soon.

Non-tradable inflation has also been driven up in recent years by strong domestic demand. Consistently, non-tradable inflation is also likely to come down with the slowdown in domestic demand in 2009.

However if this favourable forecast is to materialise as we expect, there are some important conditions that have to be in place.

First inflation expectations should remain anchored. Indexation should take account of looser future conditions, and not try to push out past adjustment in relative prices. Similarly any depreciation should not spark off further bouts of domestic inflation. A large rise in inflation expectations will cause enormous disruption to our economy at the current moment.

Also in order for domestic prices to incorporate the falls in international prices, it is crucial that we keep our trade open and promote domestic production without recourse to protectionism.

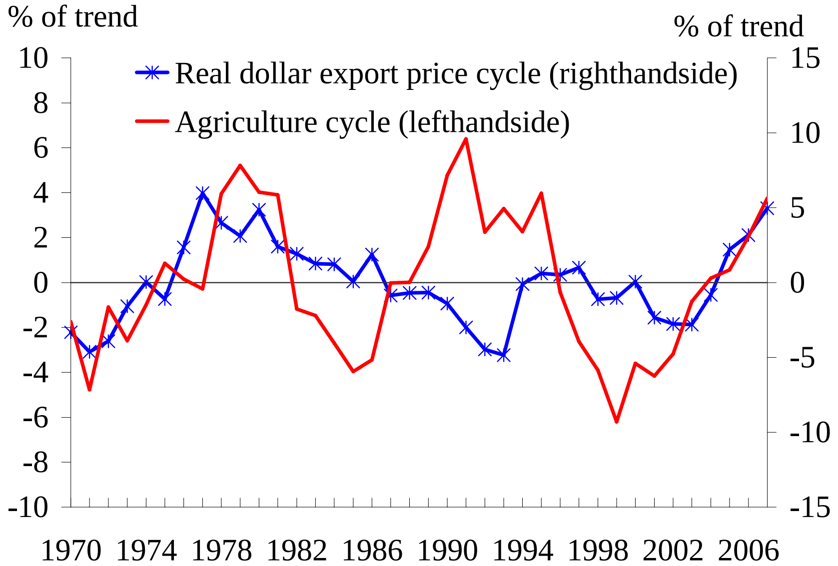
And then one of the reasons why inflation has been so slow to fall back is the continued rises in the relative prices of those goods and services which are sheltered from competition and which are regulated. For example public service consumer prices rose by 13.5% from December 2007 to December 2008. Therefore is especially important that public service prices increases are moderated going forward.

In conclusion the Banco de la República is committed to make sure that inflation returns to the lower rates enshrined in our target. Subject to that, we could continue to adopt a countercyclical policy stance. There are good reasons to forecast that inflation will fall back in 2009. But it is important that that process is not disrupted. Otherwise the scope for a countercyclical policy will be curtailed.

Paris, January 26th 2009.

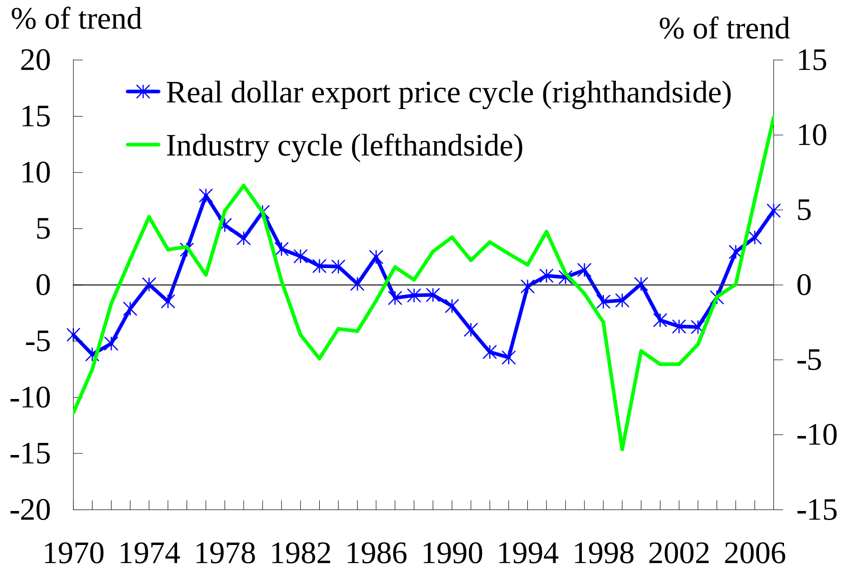
Annex

Chart A.1 Agriculture' Output and Real Dollar Export Prices (deviations from trend).



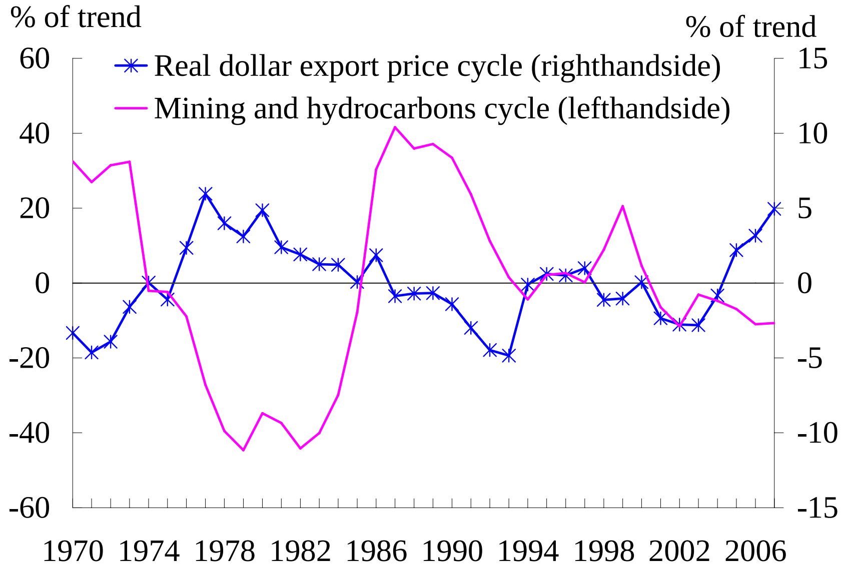
Source: DANE and Banco de la República and Mahadeva, L. and Gómez, J. (2009). "The exogenous variables that affect Colombian monetary policy", Banco de la República
Note Real dollar export prices are deflated by US CPI prior to detrending.

Chart A.2 Industry' Output and Real Dollar Export Prices (deviations from trend).



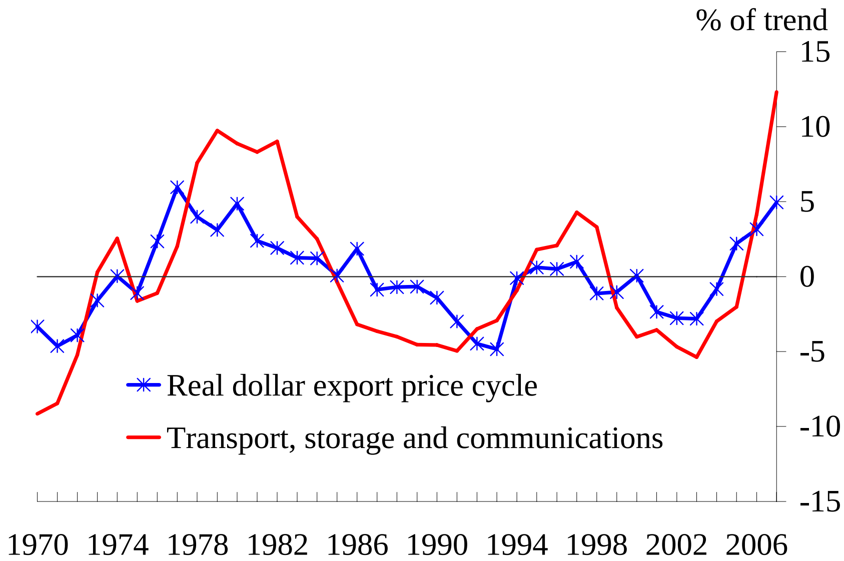
Source: See Chart A1.

Chart A.3 Mining and hydrocarbons' Output and Real Dollar Export Prices (deviations from trend).



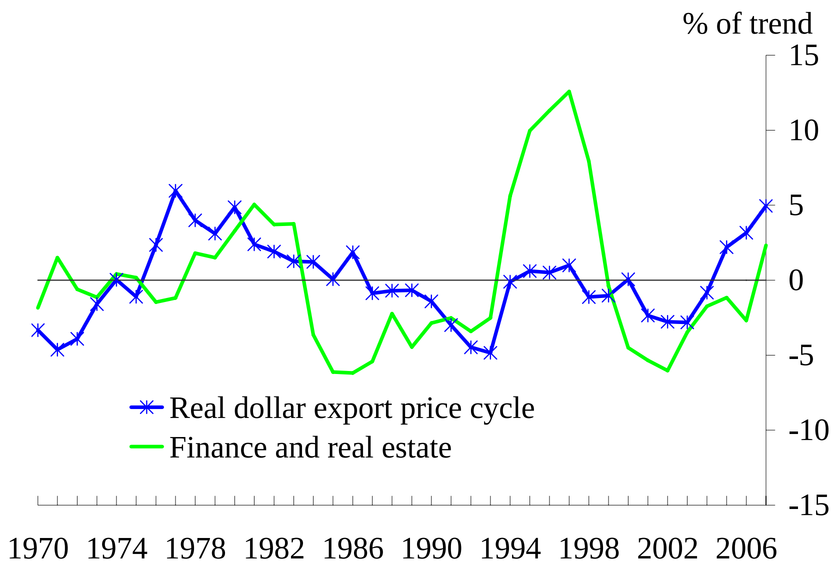
Source: See Chart A1.

Chart A.4 Transport, storage and communications' Output and Real Dollar Export Prices (deviations from trend).



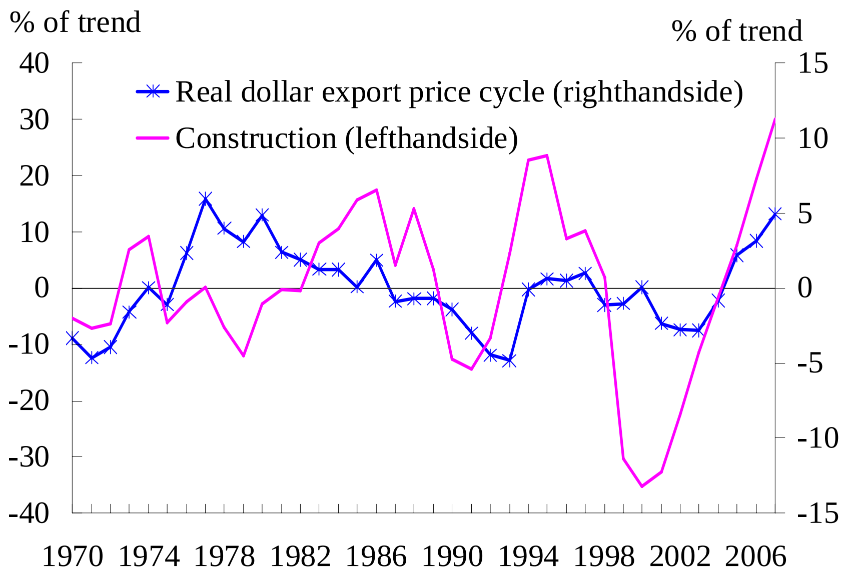
Source: See Chart A1..

Chart A.5 Finance and real estate' Output and Real Dollar Export Prices (deviations from trend).



Source: See Chart A1..

Chart A.6 Construction' Output and Real Dollar Export Prices (deviations from trend).



Source: See Chart A1.