Monetary Policy in Colombia

Trade offs and policy dilemmas

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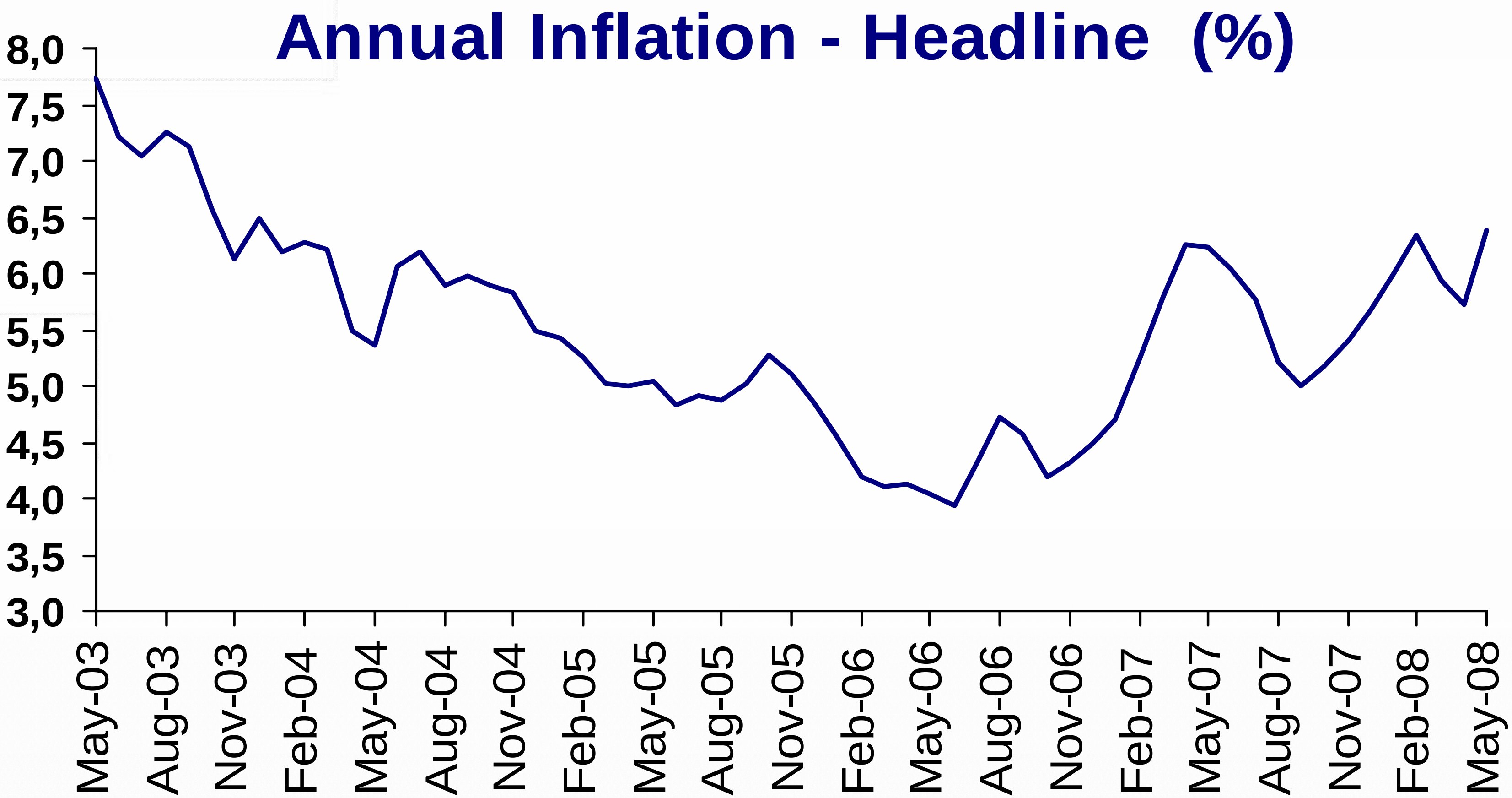
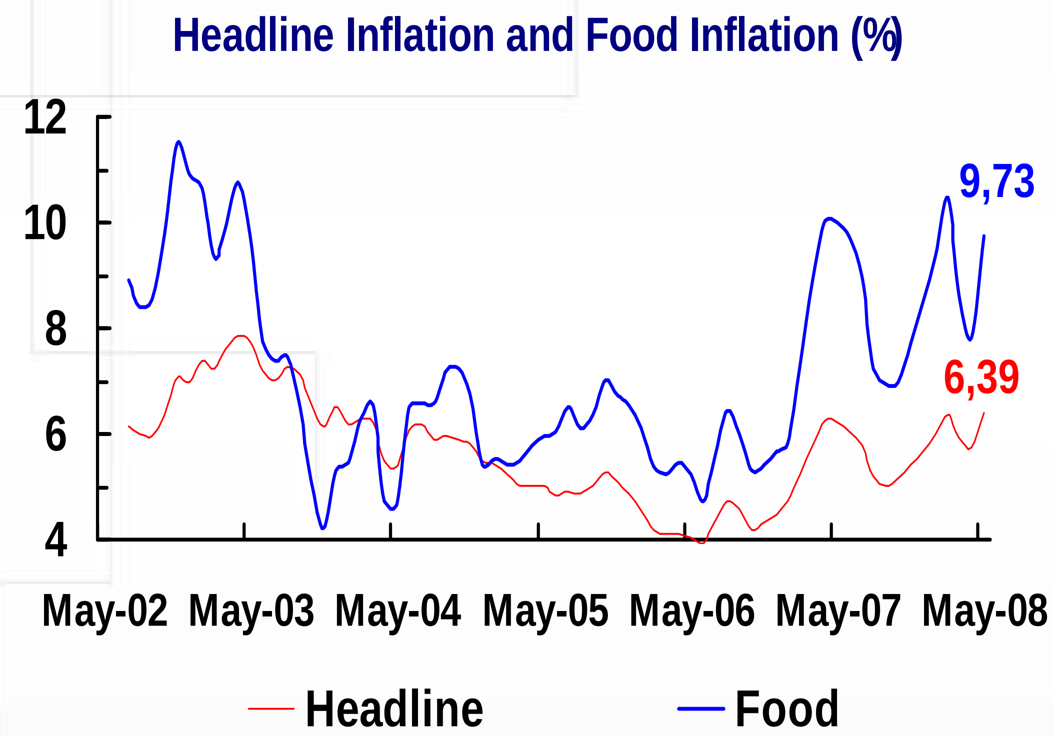
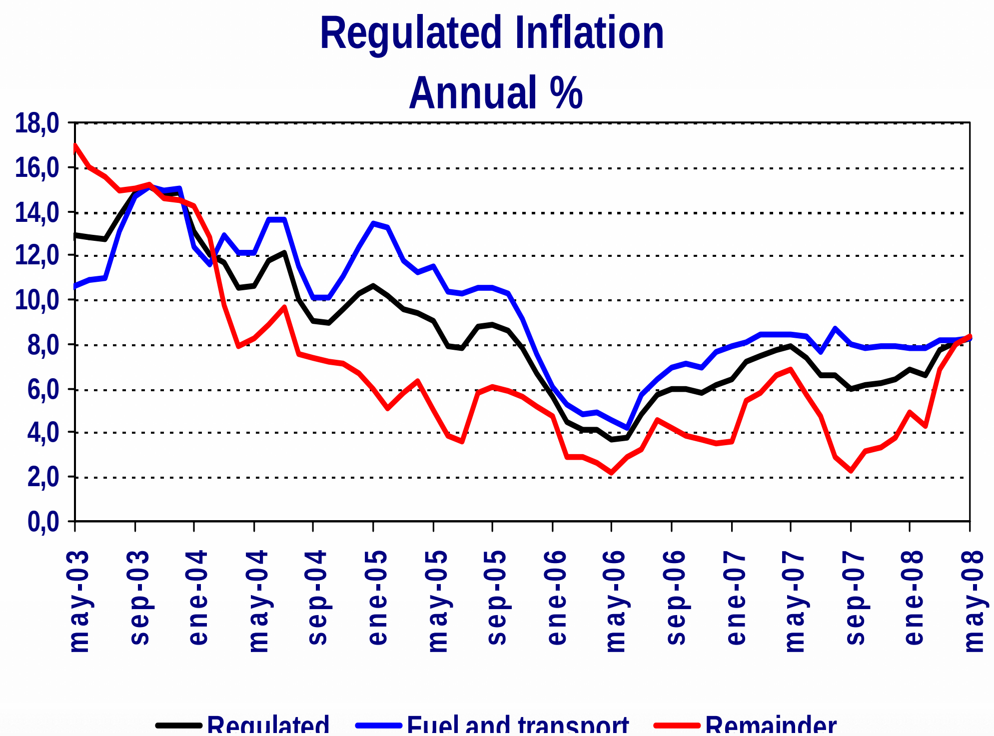
By the last quarter of 2006 inflationary pressures started to show up. The inflation target was missed in 2007 and current inflation continues well above the target range.



Source: DANE, Banco de la República.

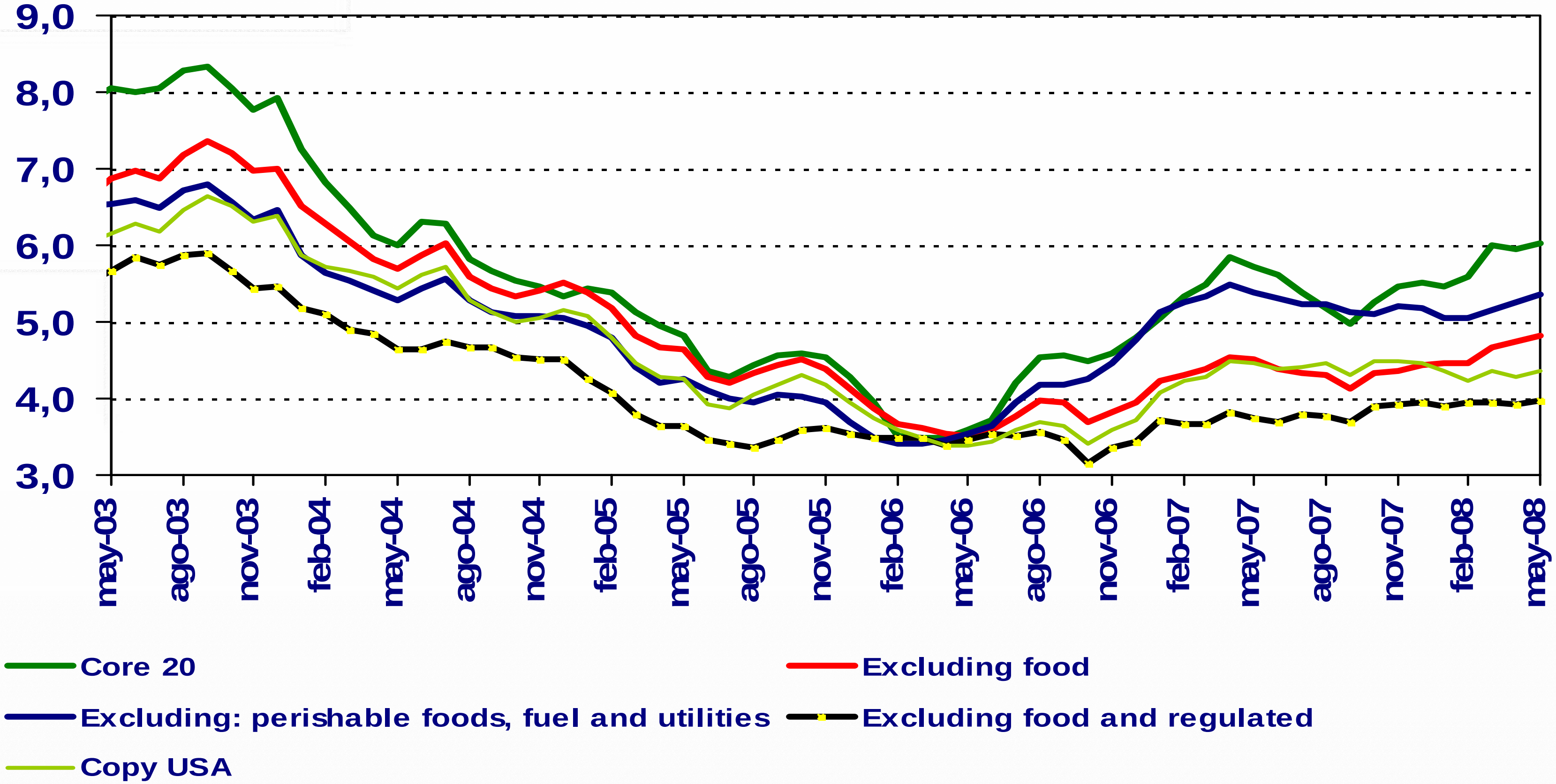
Most of inflationary pressures are explained by an increase in food prices, with contribution to total inflation in 2007 of 46%. Oil prices, has also put pressure on inflation





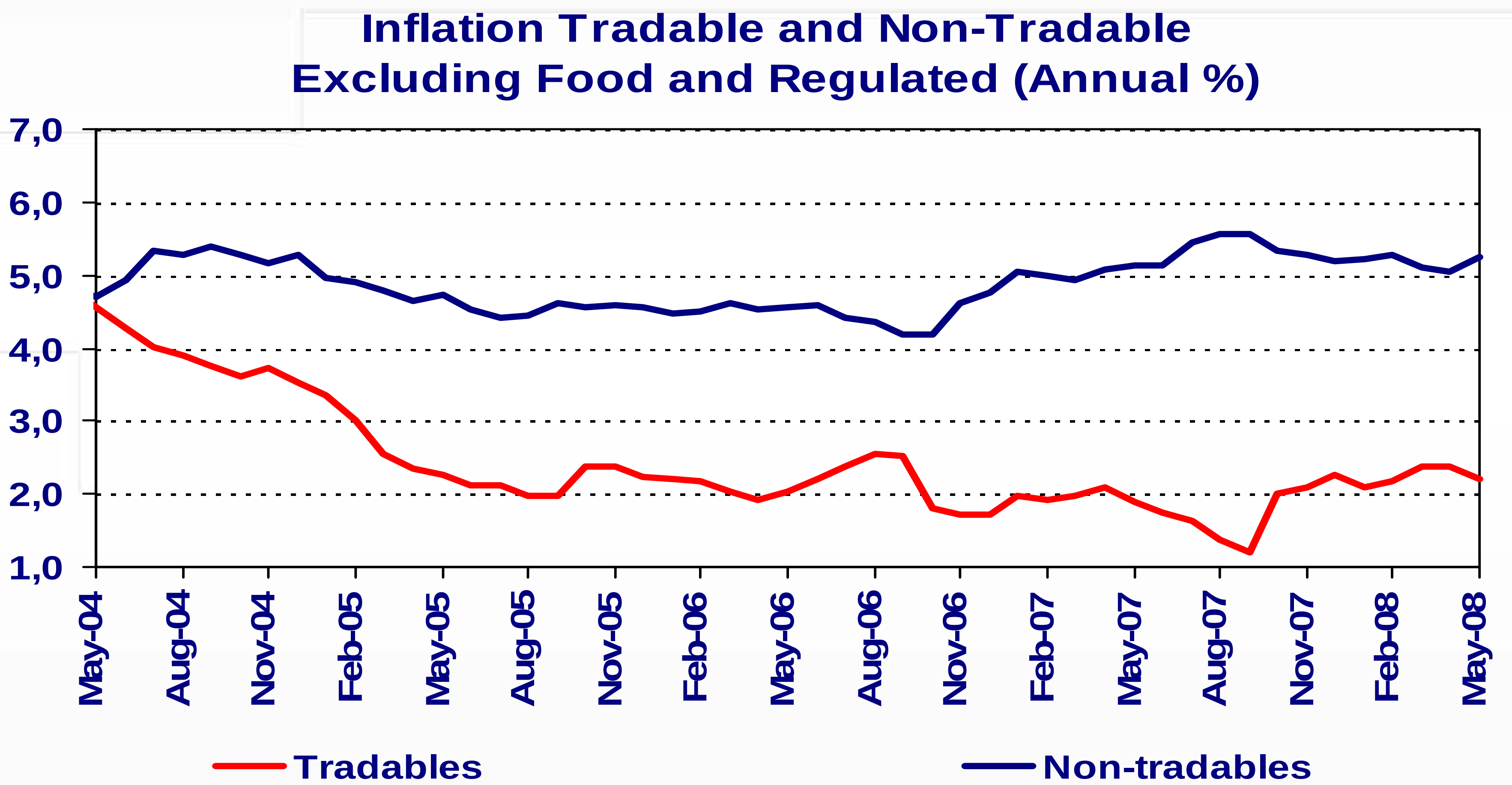
Nonetheless, there are more than supply shocks in the explanation of inflation. In fact, different measures of core inflation show an upward trend. Hence, excess demand has also played an important role.

Measures of core inflation



Source: DANE and Banco de la República.

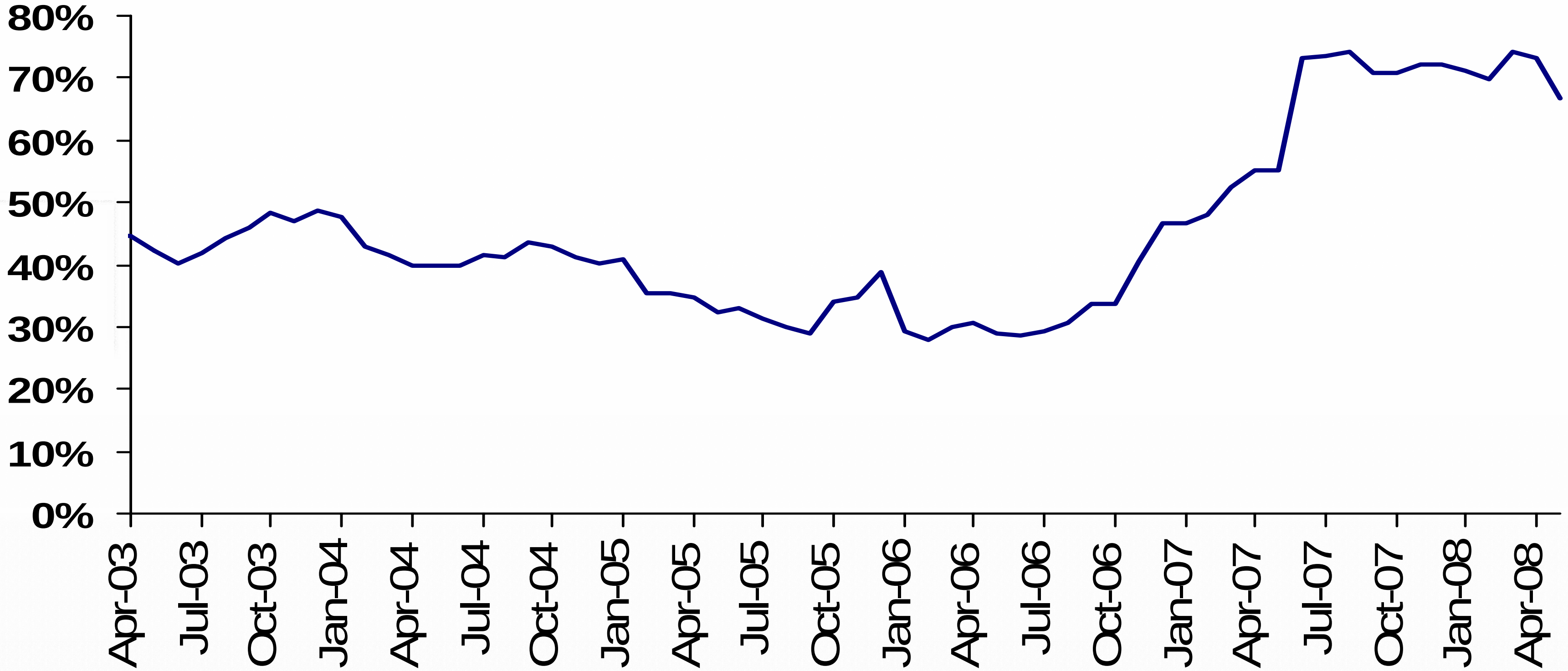
Inflation of tradable goods (excluding food and regulated) remains positive, hovering around 2%, despite the sharp appreciation of the peso (11.8% in the last 12 months). Non-tradable goods inflation is stagnant above 5%



Source: DANE and Banco de la República.

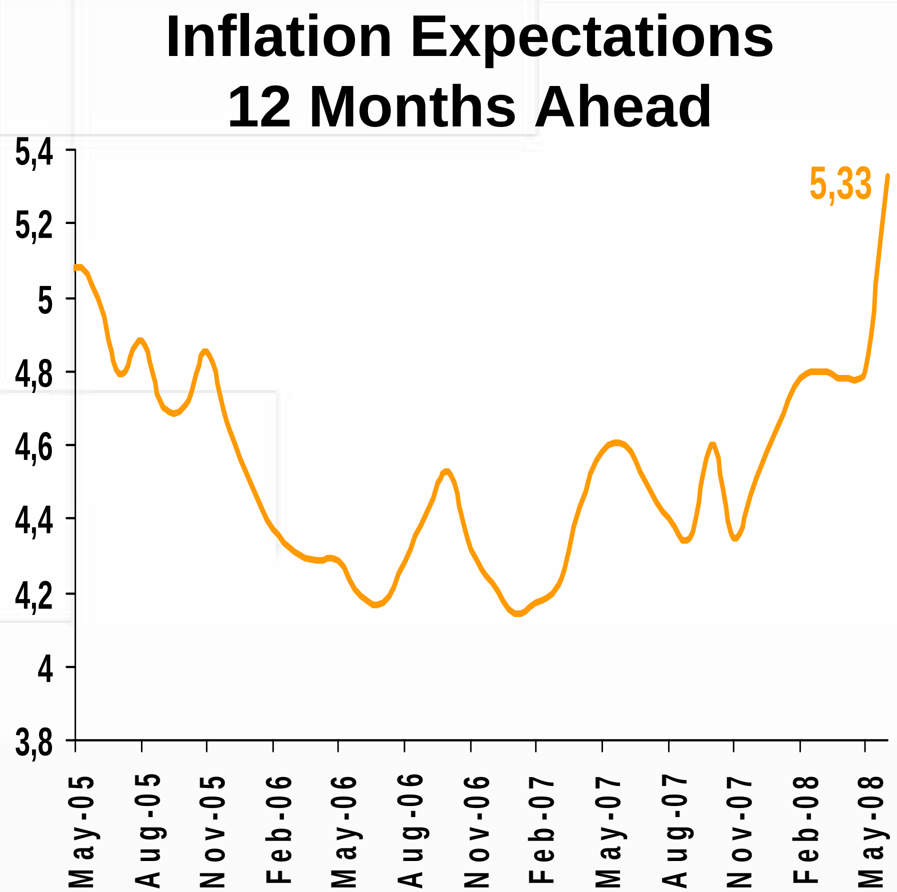
The diffusion indicator, that is, the weighted percentage of items of the consumer's basket whose annual inflation is above the mid-point target range, reaches 70 percent

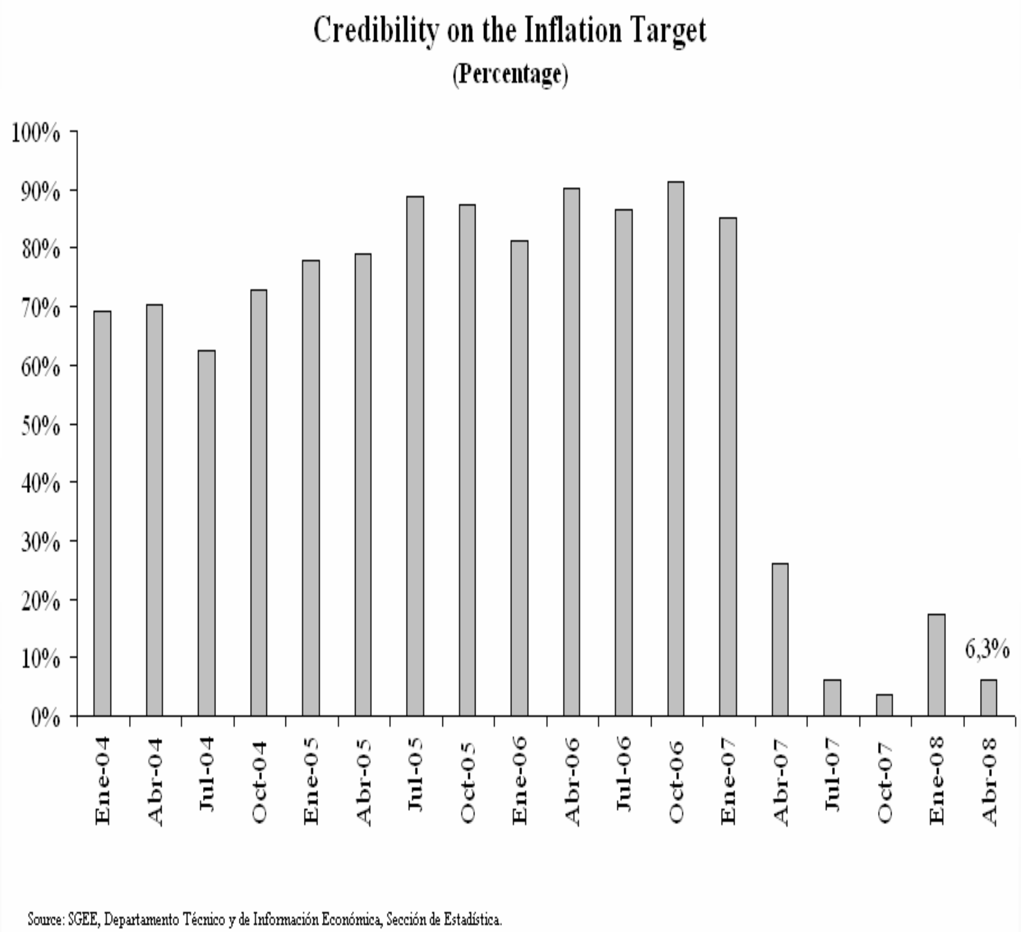
Difussion Indicator



Source: DANE, Banco de la República.

The rise in inflation an its diffusion to many goods, have increased inflation expectations and have reduced the credibility on the inflation target

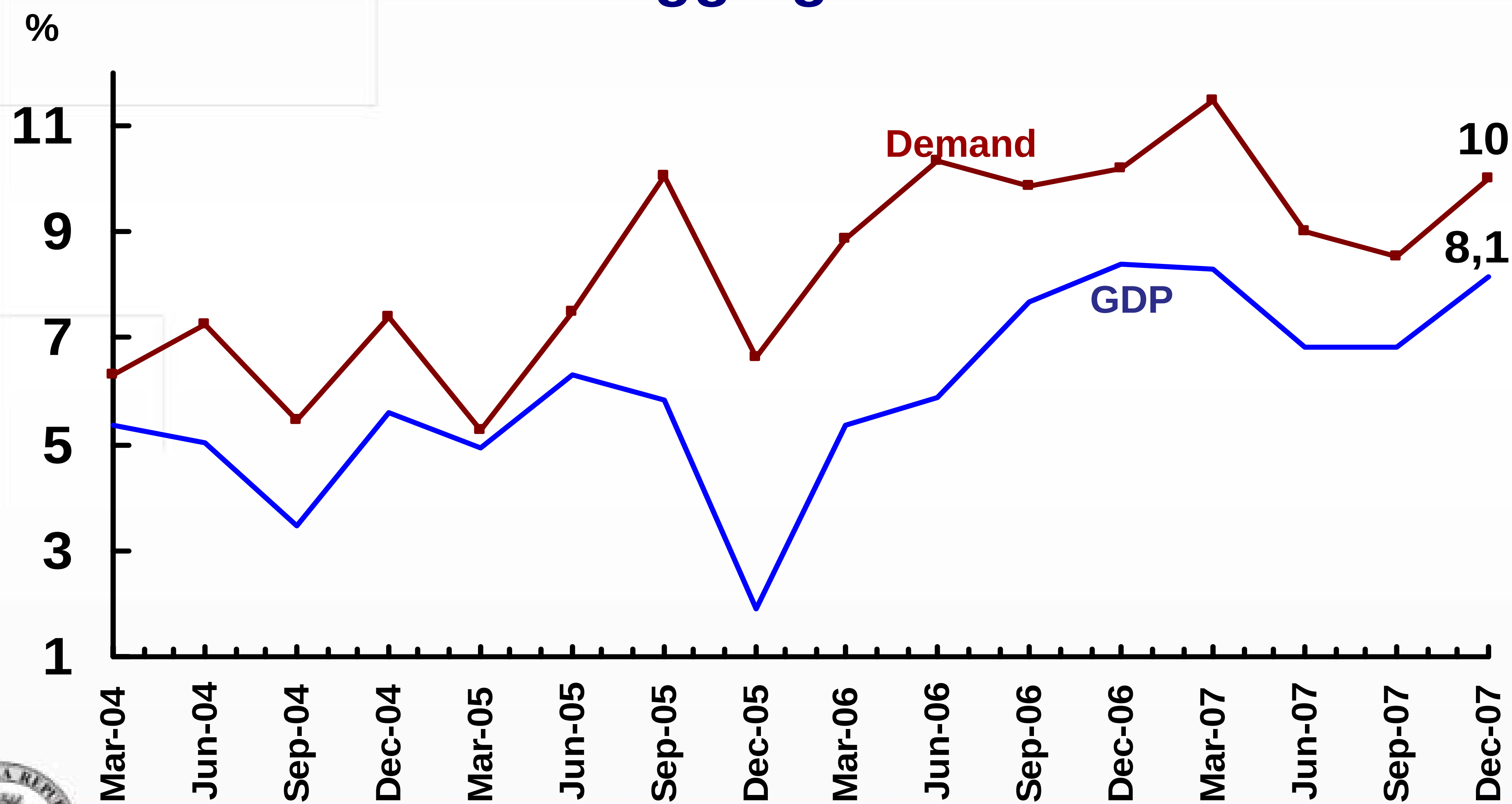




Source: Banco de la República.

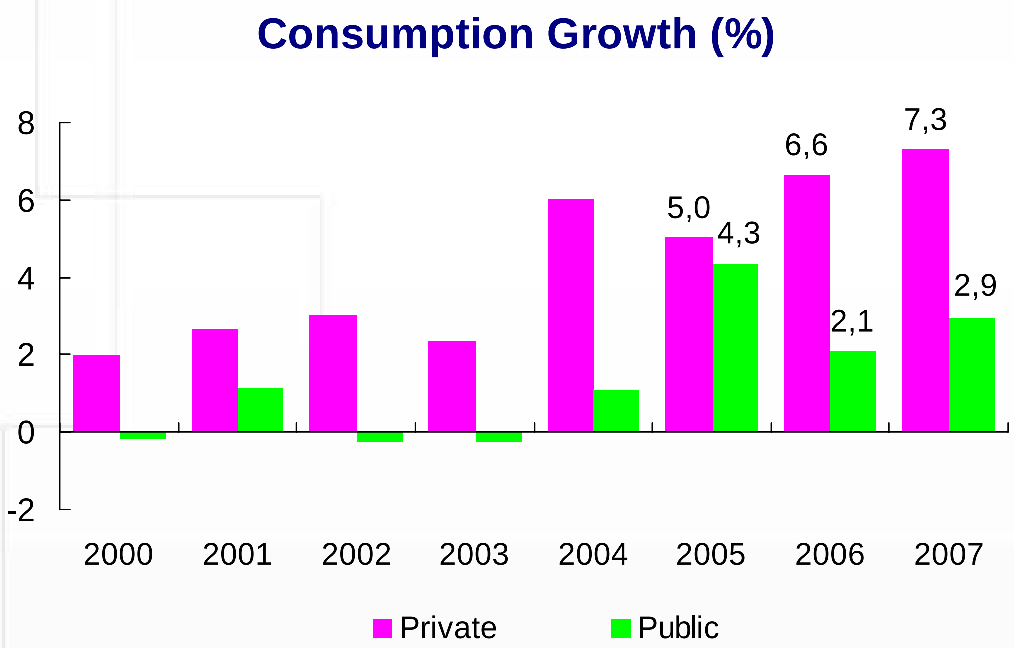
Inflation accelerated in a context of rapid economic growth, supported by a vigorous demand.

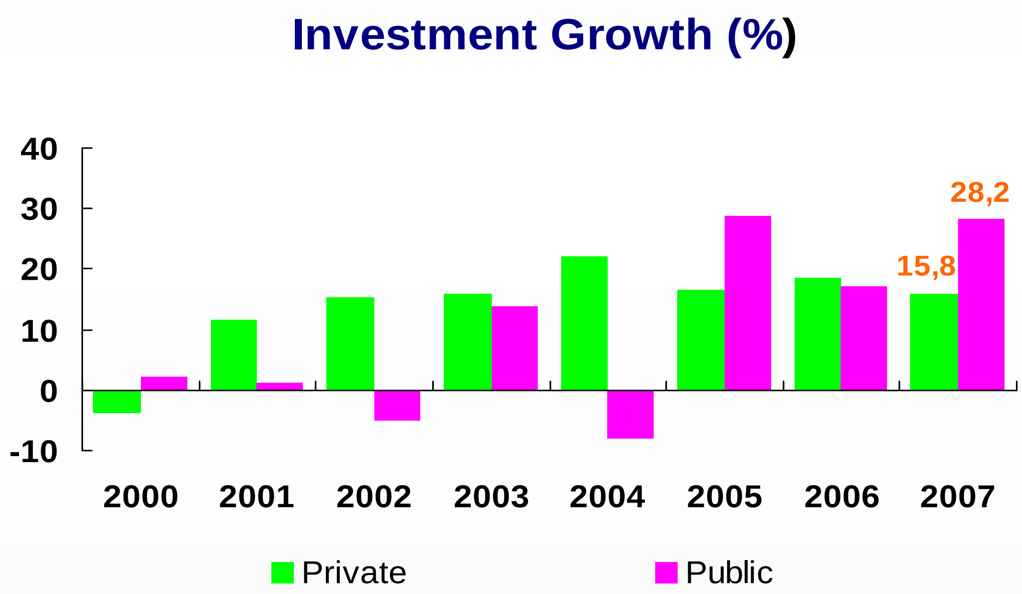
GDP vs Aggregate Demand



Source: DANE, Banco de la República.

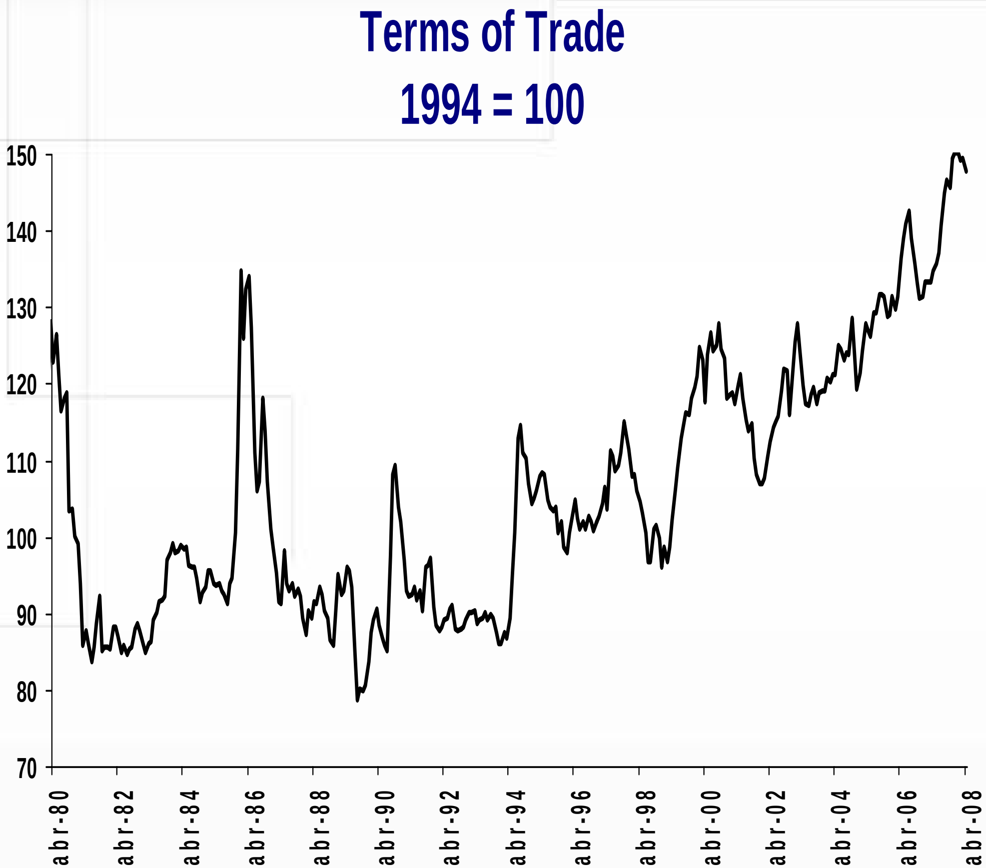
Expansion of aggregate demand is explained by a strong investment and consumption growth, associated with a rise of market confidence

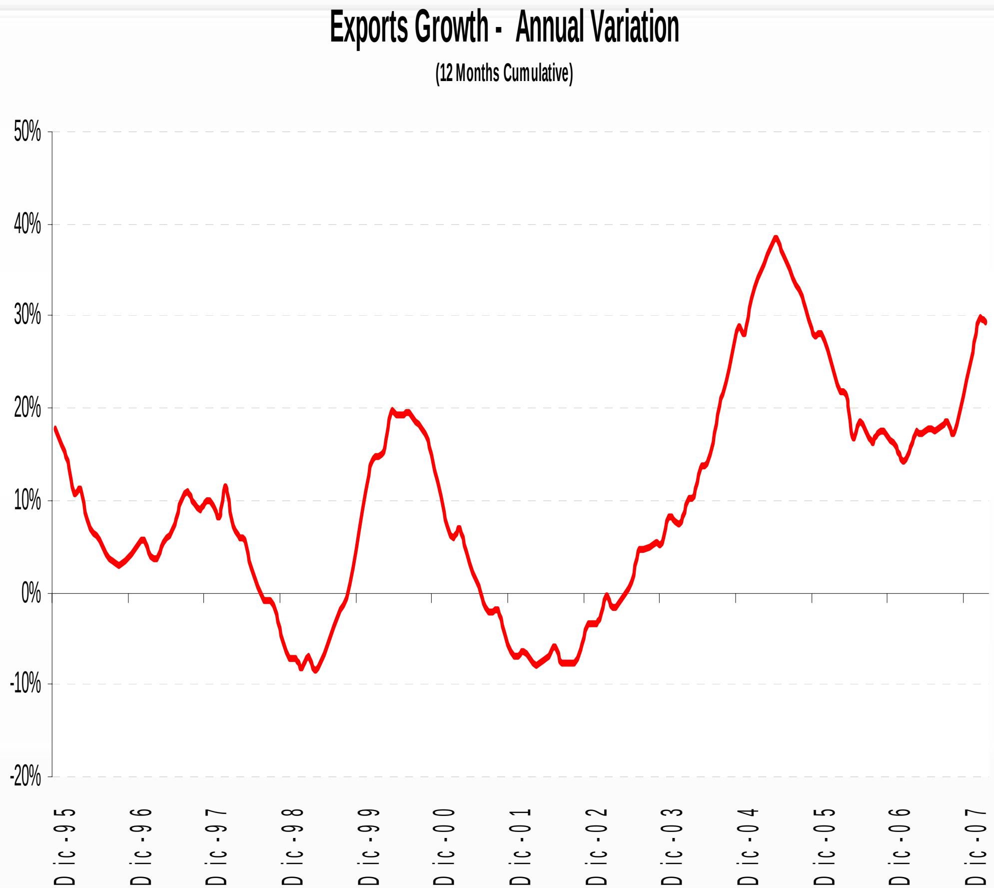




Source: DANE, Banco de la República.

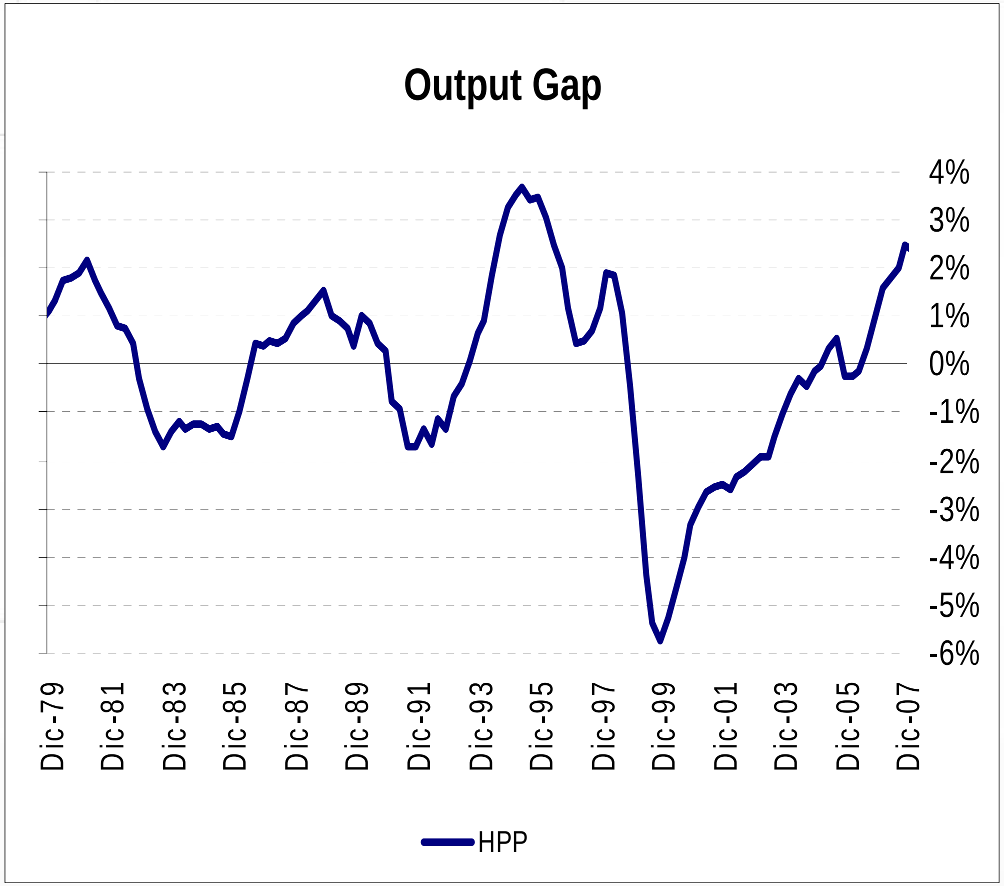
In addition, favorable terms of trade induced a rapid exports growth

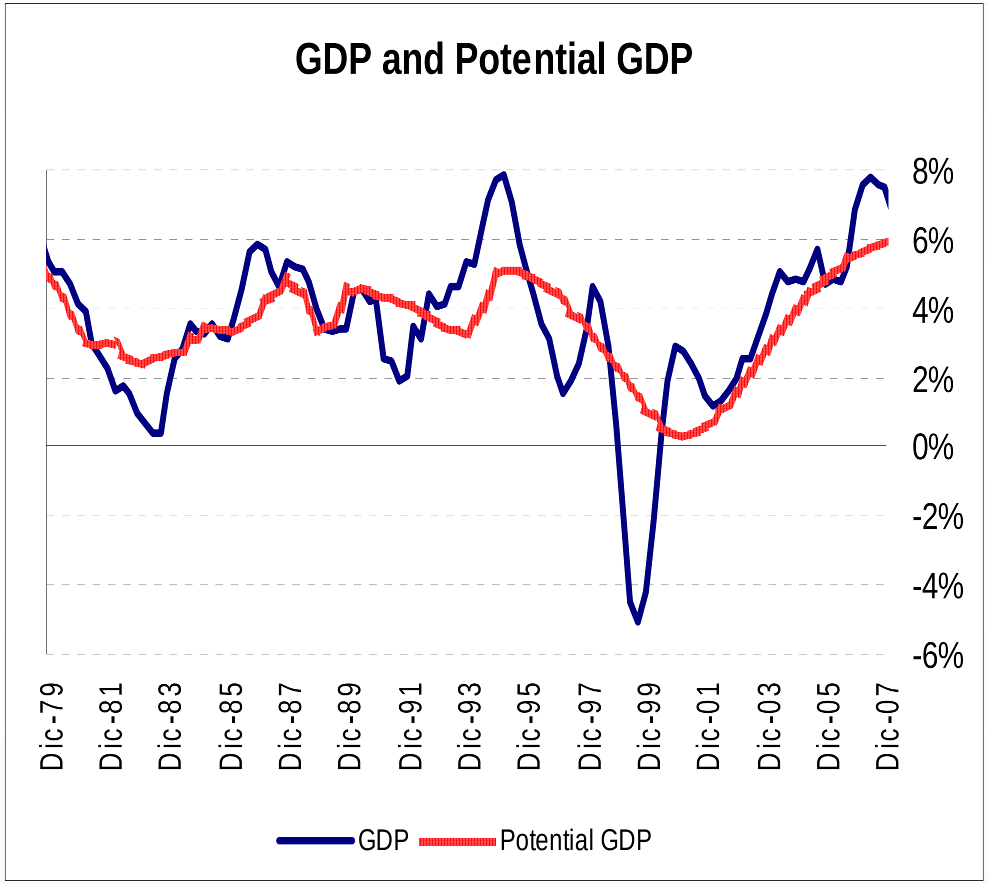




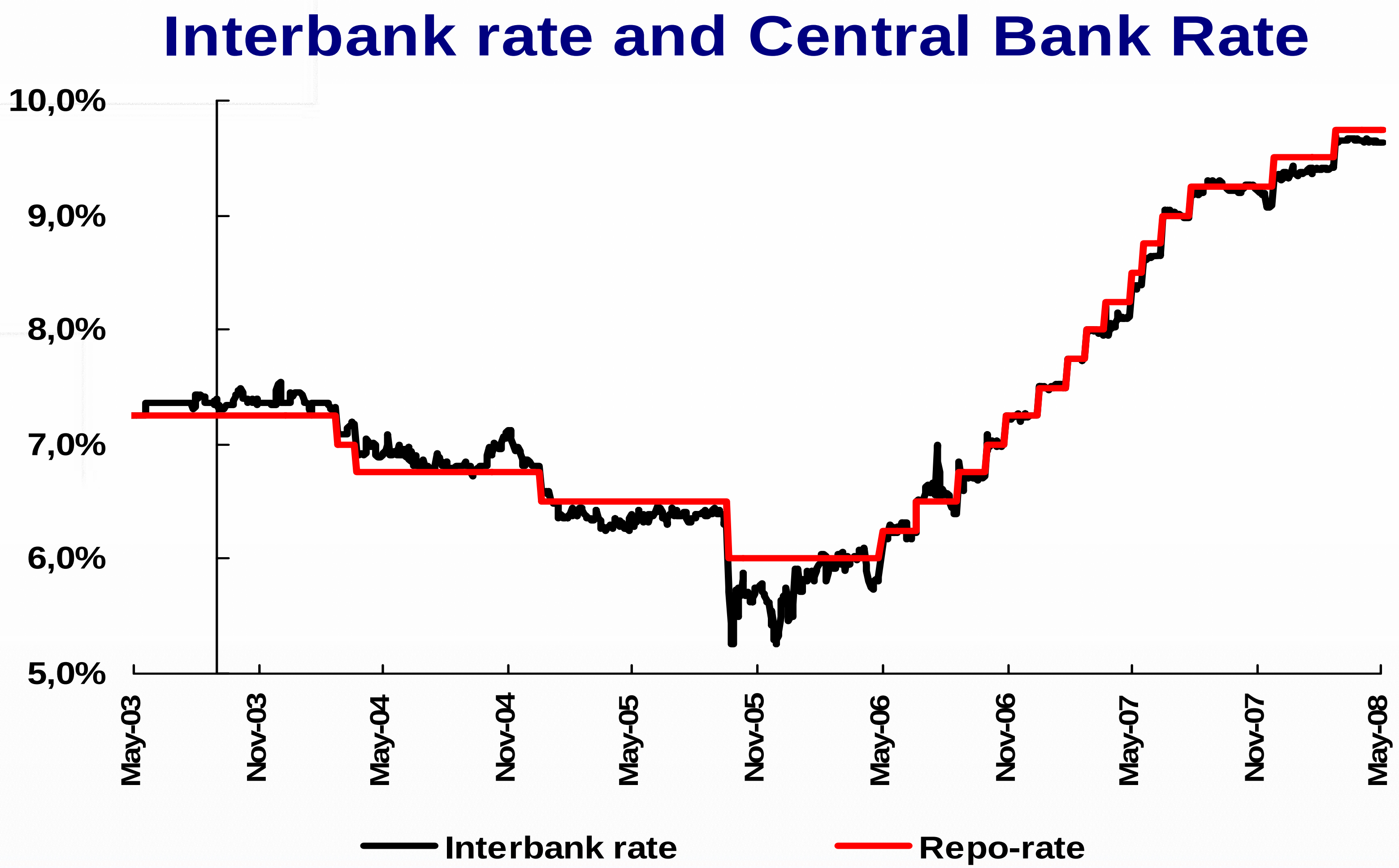
Source: DANE

Strong demand resulted in an increasingly positive output gap, despite a rise of potential GDP. Output gap is currently estimated in a range of [2.0 - 2.5] percent.



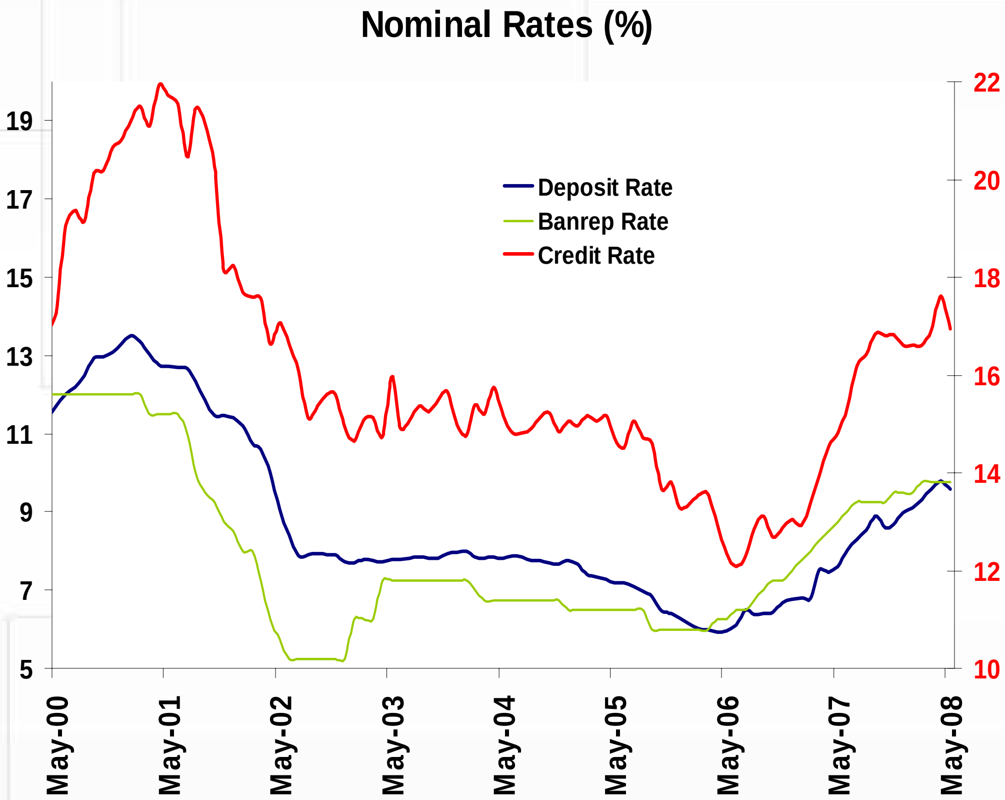


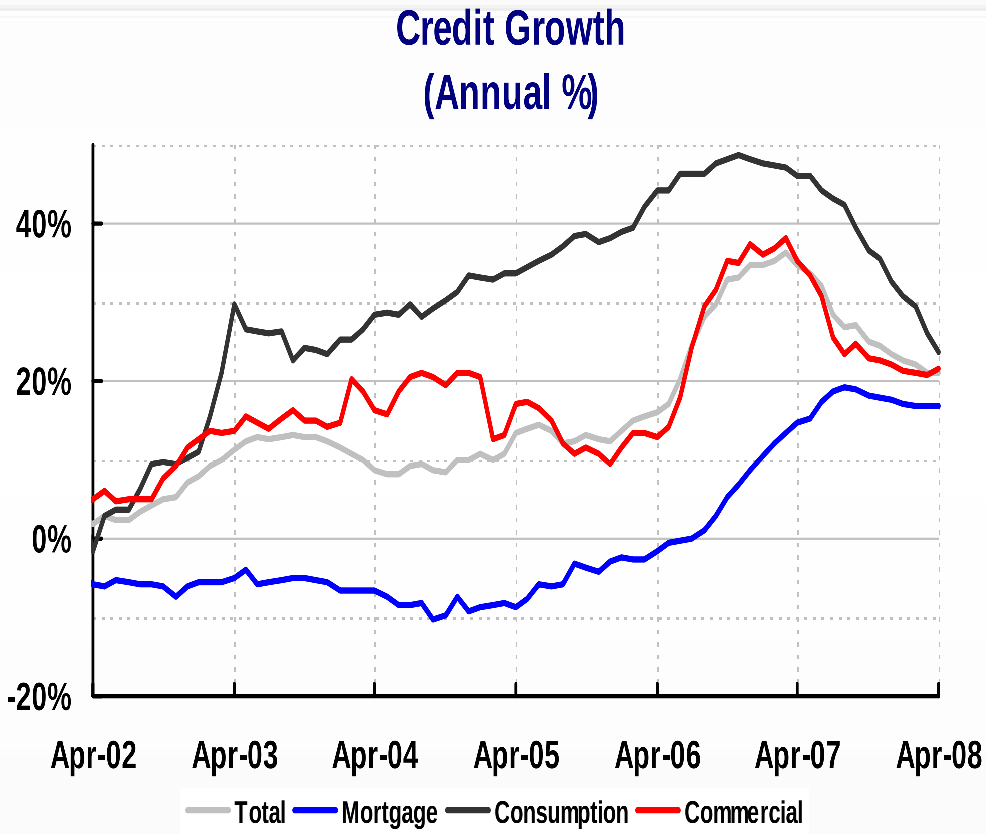
In a context of rapid growth and inflationary pressures, the central bank decided in April 2006, to start a gradual raise of interest rates. From an initial level of 6%, interest rates have been increased to 9.75%.



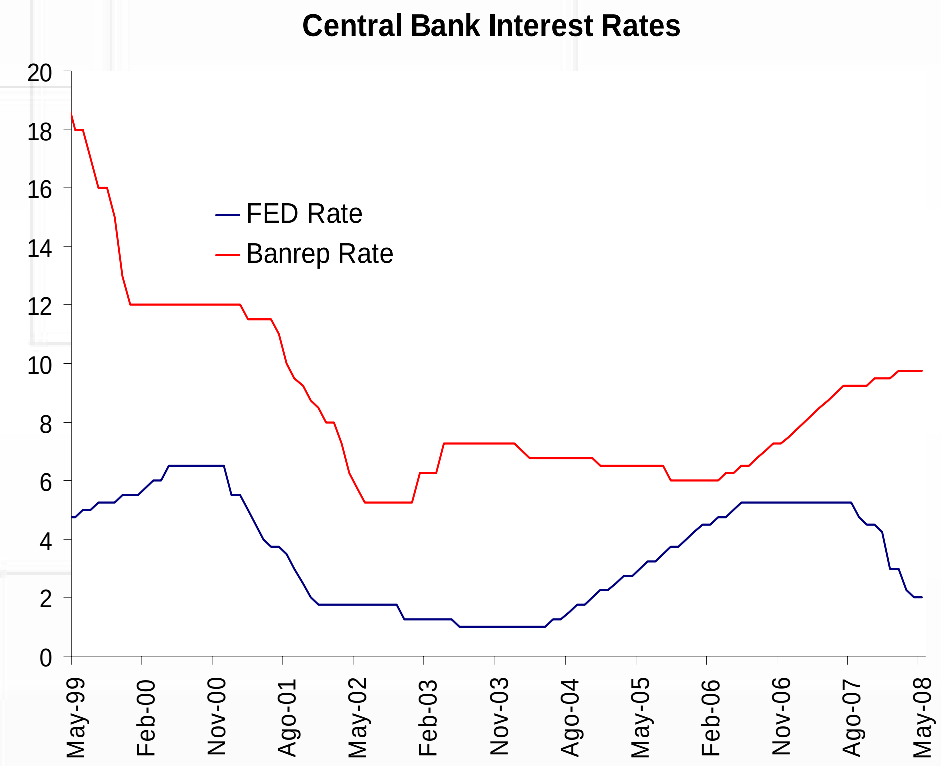
Source: Banco de la República.

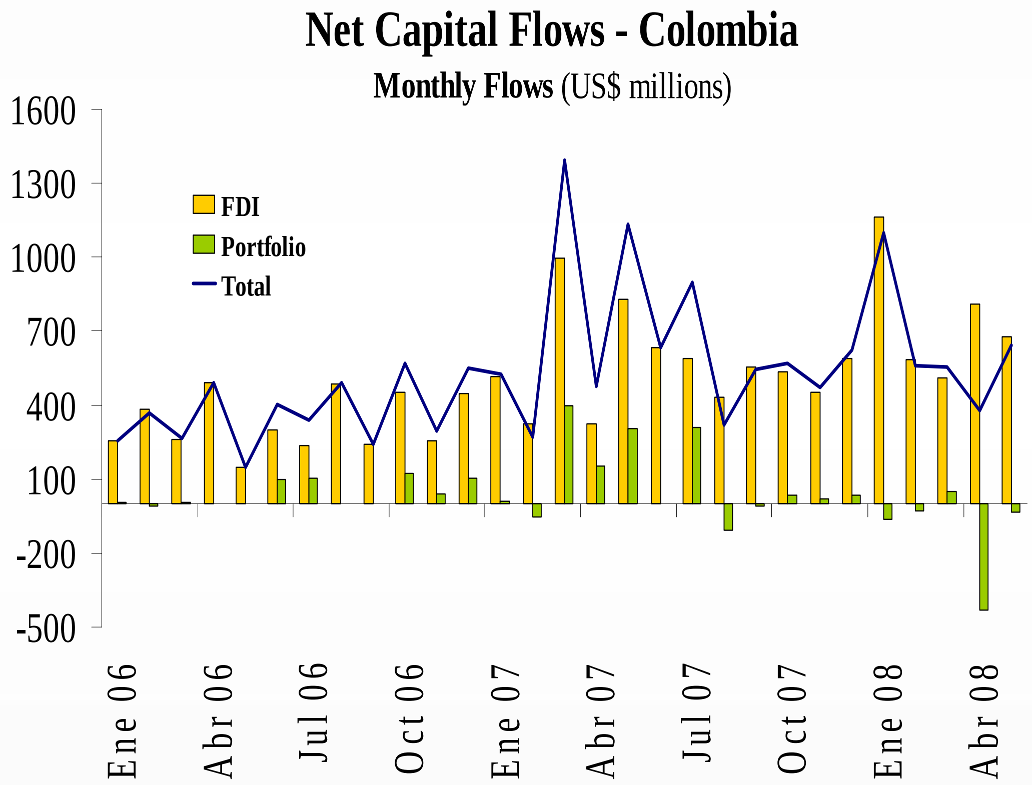
The rise in the central bank rate was eventually reflected in higher of market rates and in a slowdown of credit growth





At the same time, higher interest rates widened the interest rate differential. Nonetheless, portfolio flows were discouraged by capital controls. Most capital inflows are FDI.

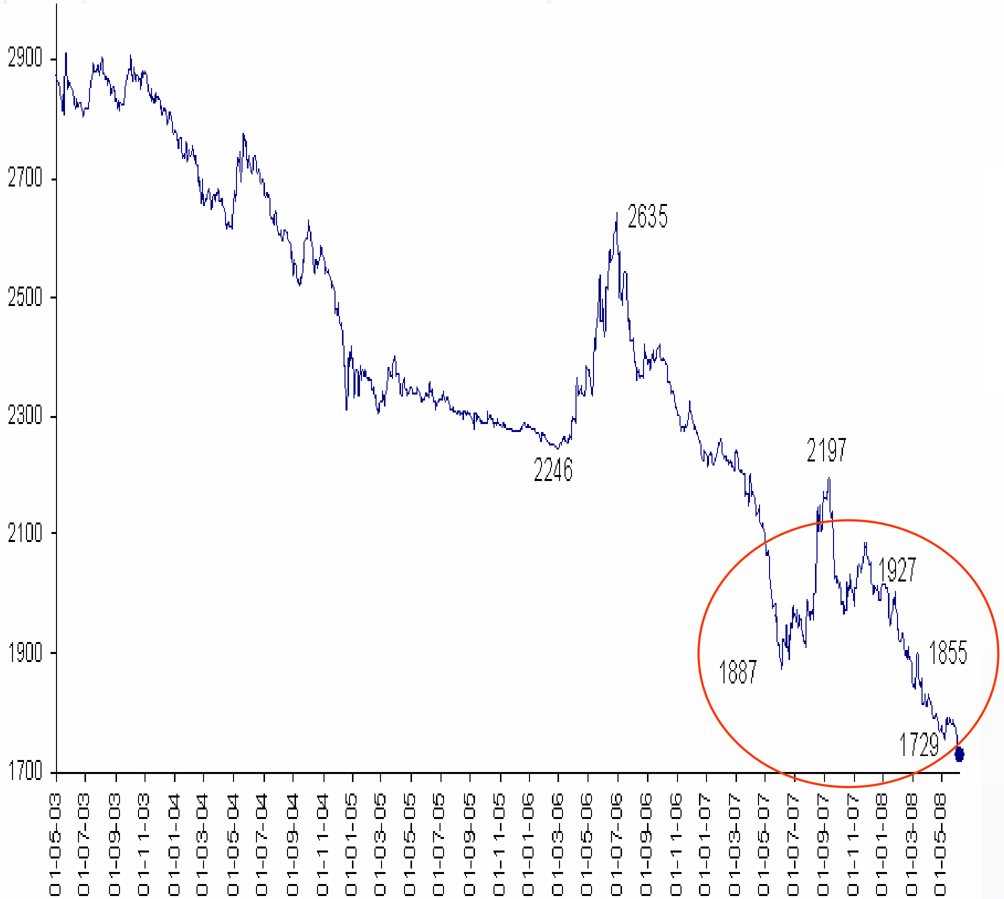




Source : Banco de la República

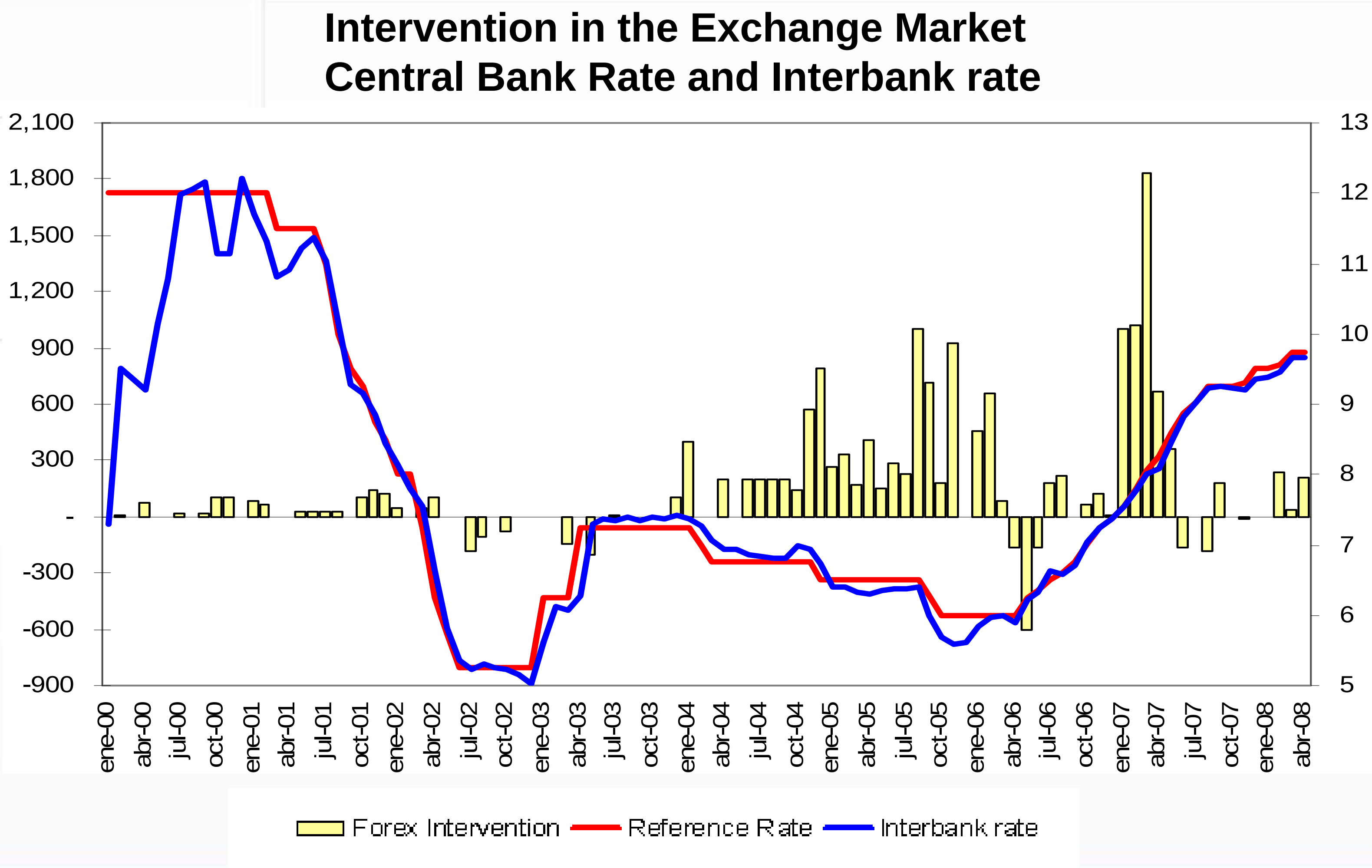
Despite active intervention in the foreign exchange market, appreciation of the Colombian peso has turned unstoppable.

Nominal Exchange Rate

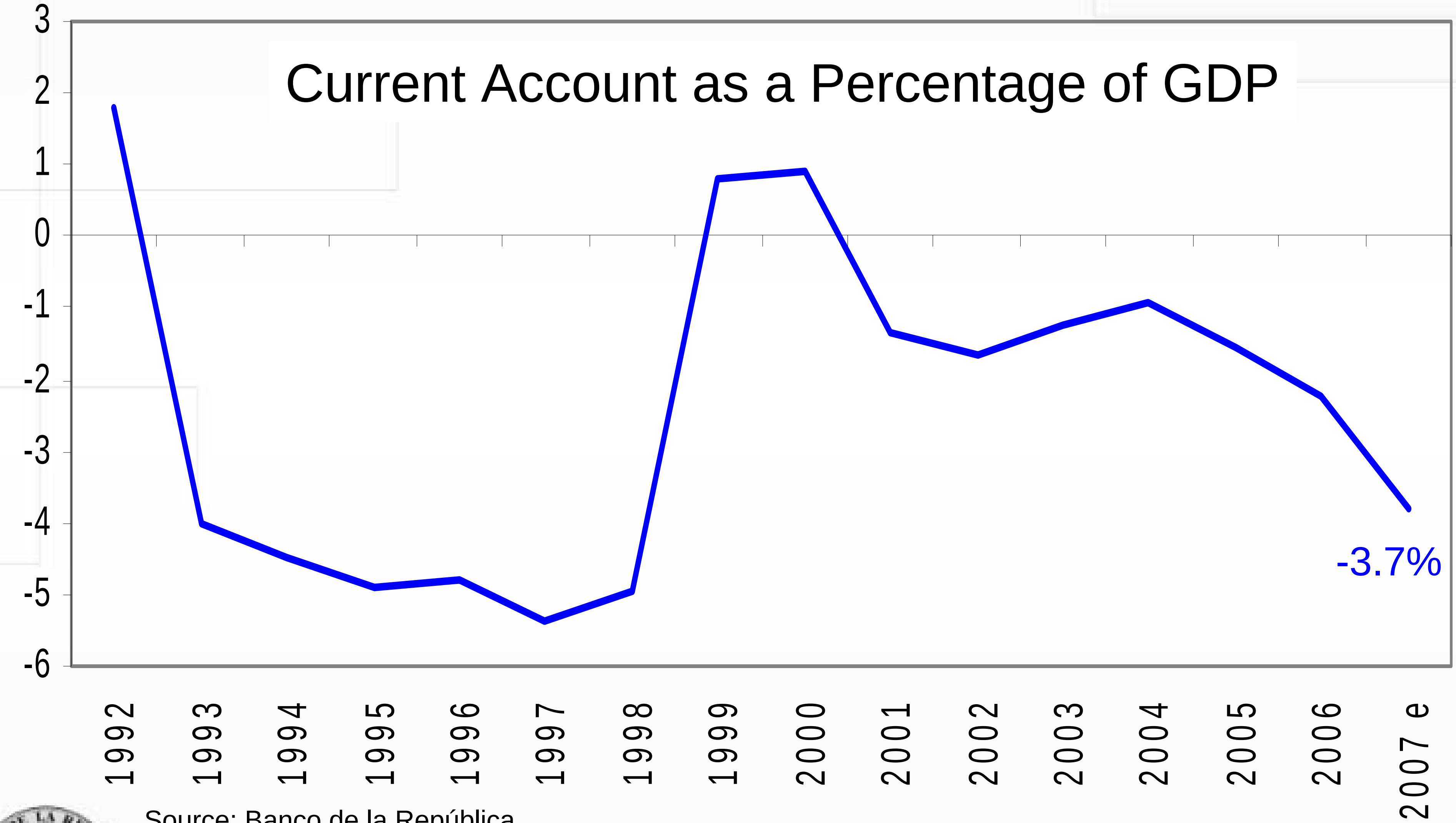


LATAM	Changes in Exchange Rates Against the US$			
	Last Month	Year to Date	Year to Year	Last 3 Years
Colombia	-4,27%	-15,52%	-11,80%	-27,24%
Brasil	-1,48%	-7,86%	-16,73%	-32,93%
México	-0,92%	-4,79%	-5,71%	-4,28%
Argentina	-3,62%	-3,10%	-0,69%	6,03%
Perú	5,28%	-2,84%	-8,15%	-10,42%
Uruguay	-2,43%	-9,64%	-18,14%	-18,53%
Chile	6,43%	-0,28%	-6,32%	-15,80%

Ineffectiveness of Forex intervention was partly due to conflicting signals provided by a contractionary monetary policy and an expansionary intervention policy. The weakening dollar added pressure on the peso.

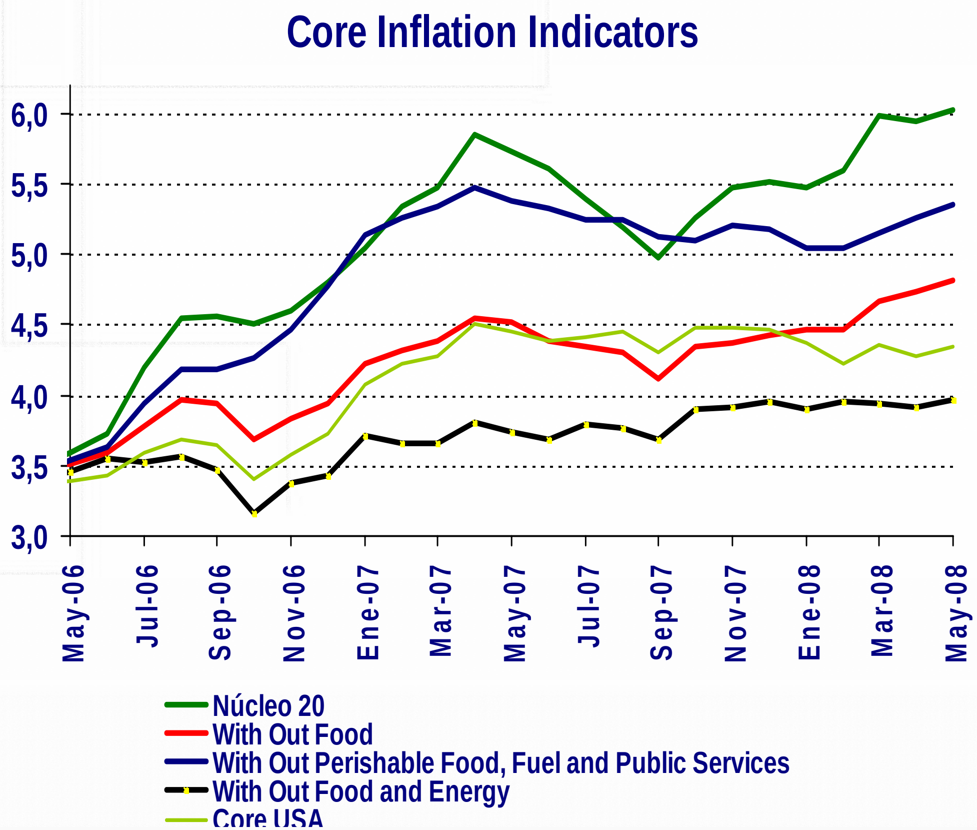


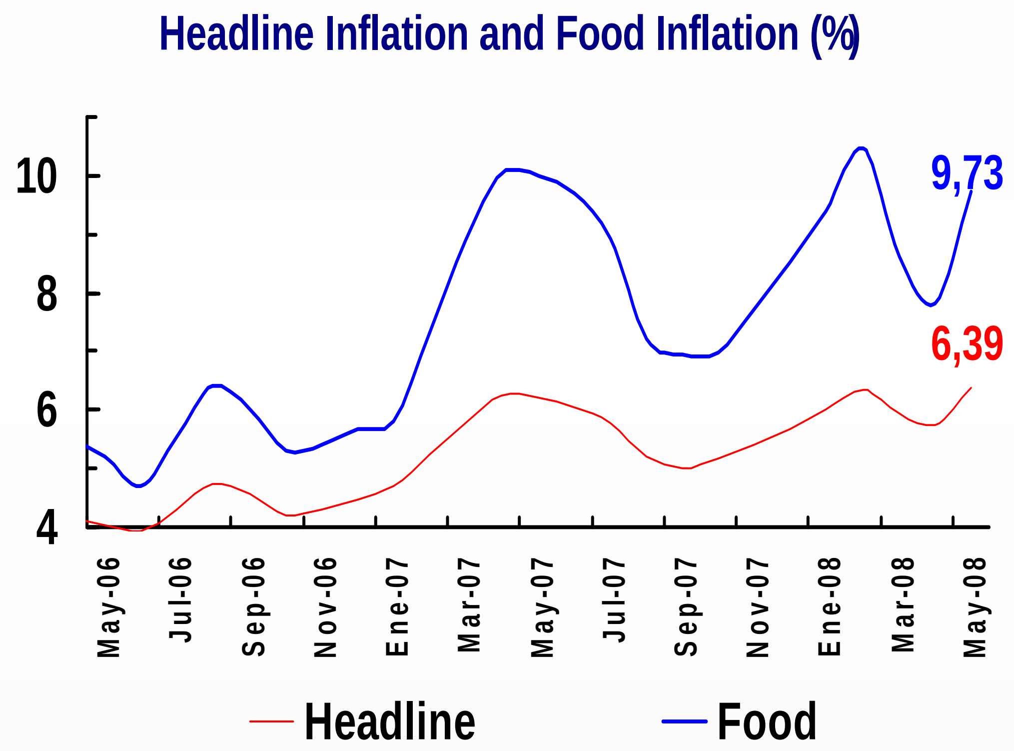
Rapid economic growth and appreciation of the peso have resulted in an increasingly current account deficit.



Source: Banco de la República

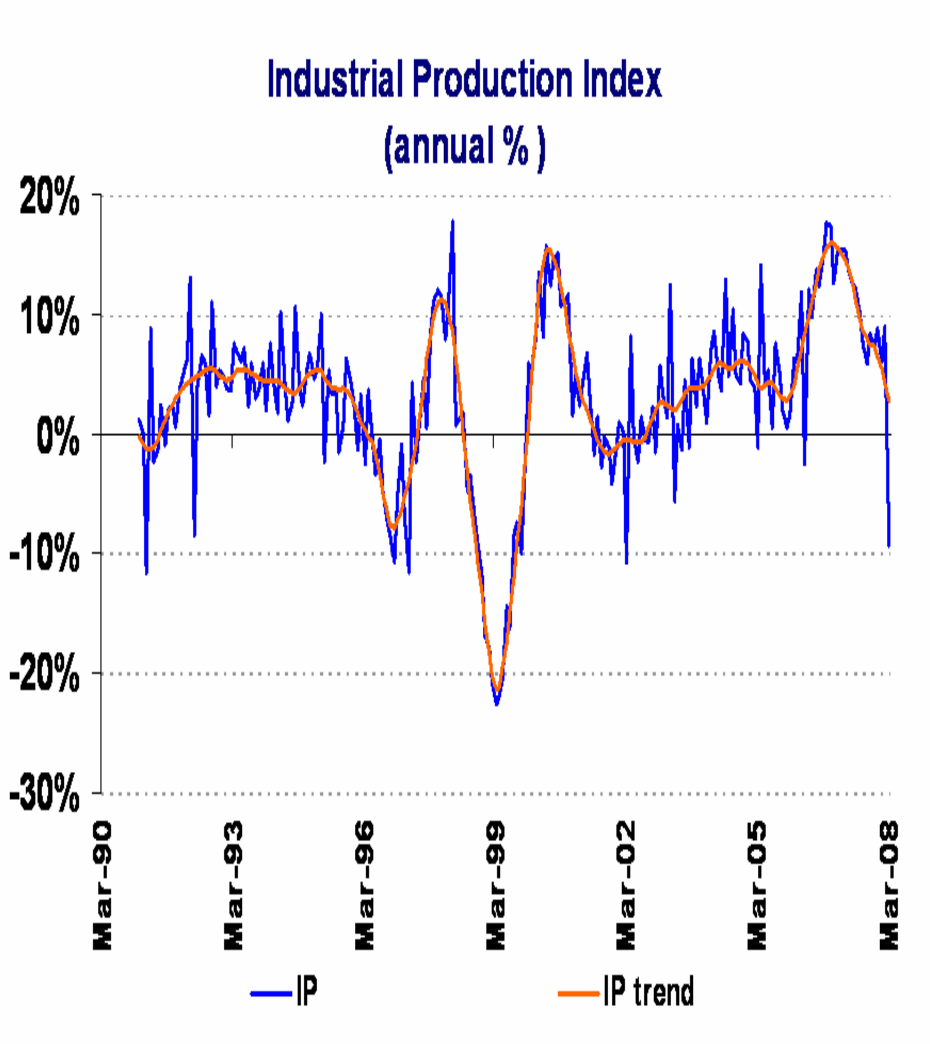
Despite a firm contractionary monetary policy, inflationary pressures remains strong

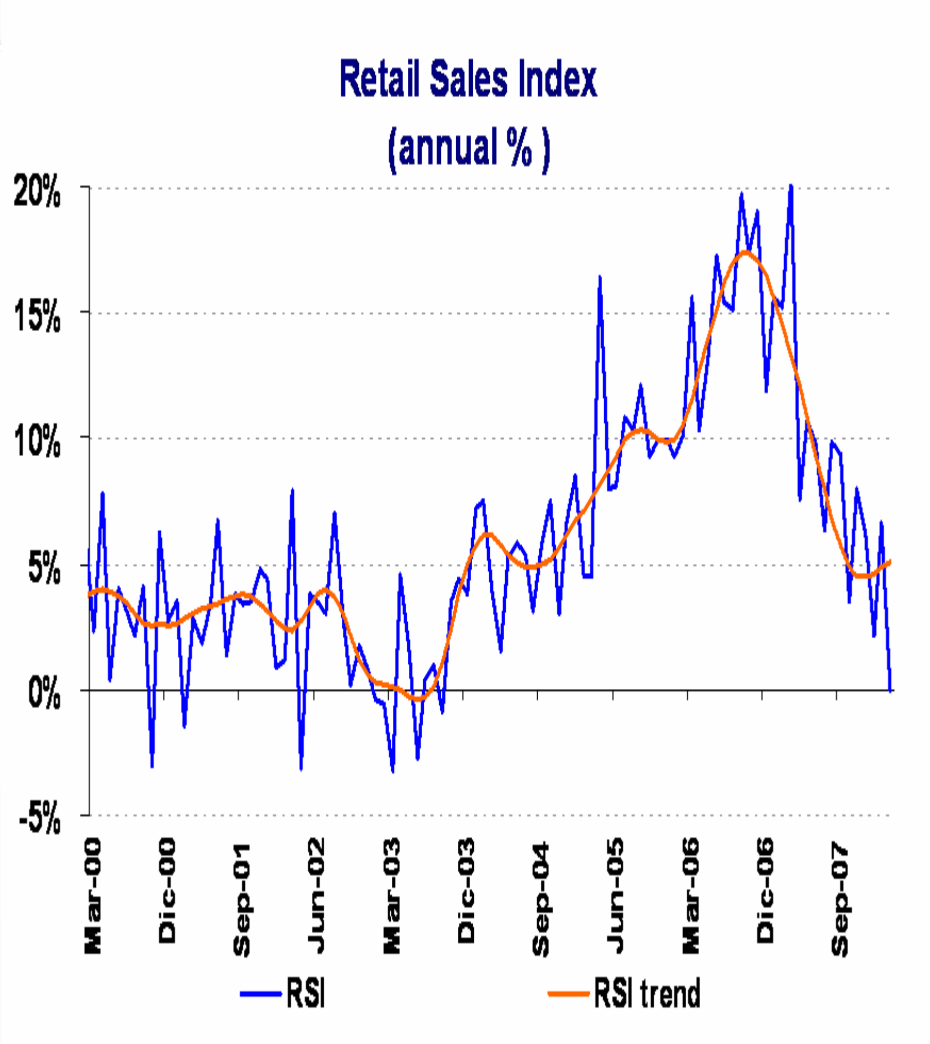




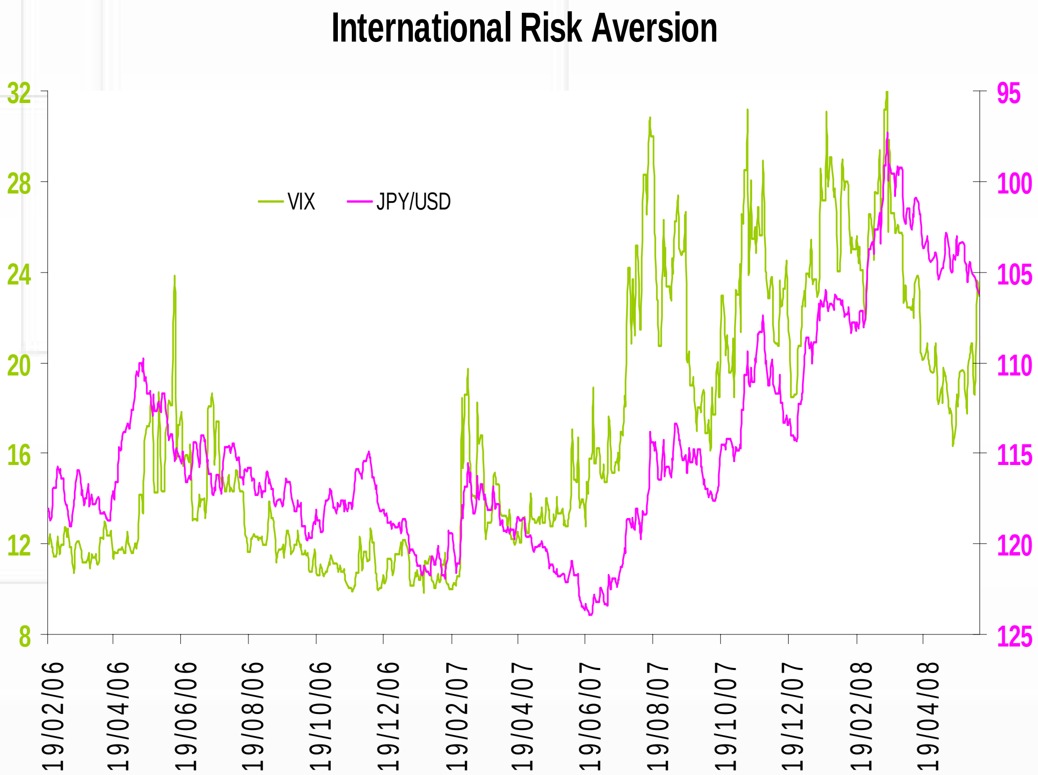
Source: Banco de la República

At the same time, there are clear symptoms of a recent slowdown of economic activity, while appreciation of the peso is turning more acute

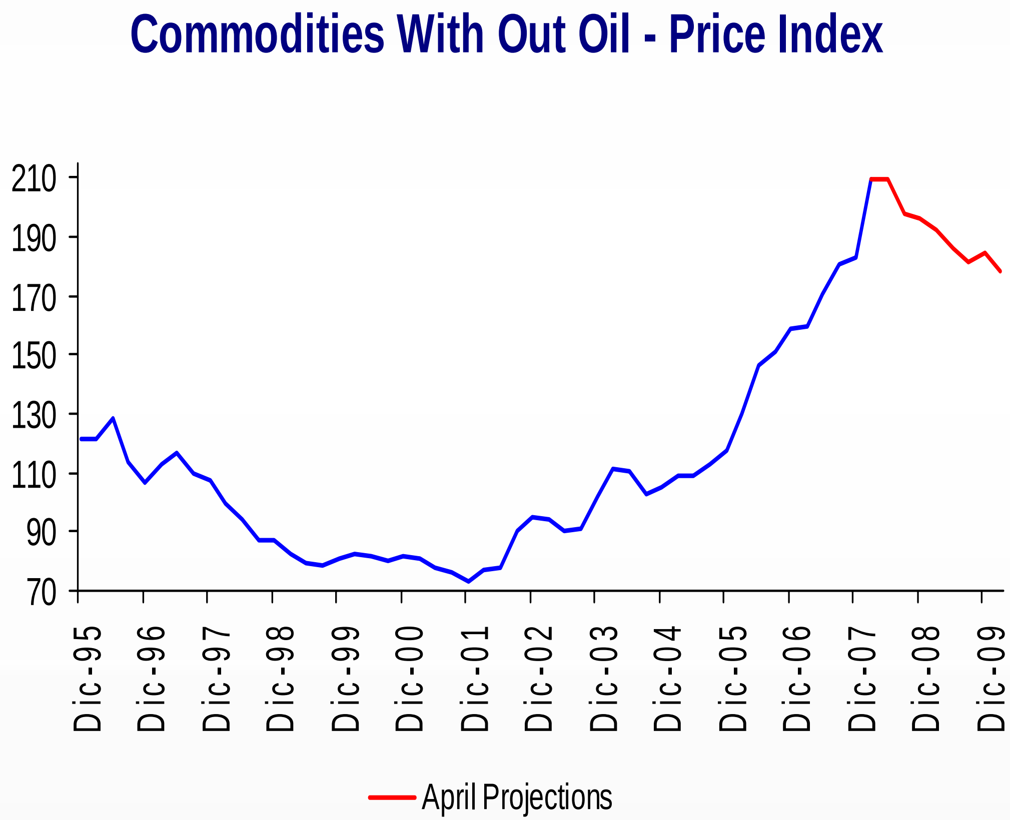




Uncertainty on the evolution of the world economy, and on its impact on emerging economies, makes particularly difficult at this juncture to assess the right direction of monetary policy.



Source Bloomberg



Source: EIU

In these circumstances, monetary authorities, both in Colombia, an in many other emerging economies, face challenging dilemmas:

1. Rising interest rates could exacerbate appreciation, but might also be required to tame inflationary pressures

2. Rising interest rates might be deemed indispensable to contain inflationary pressures, but entails the risk of inducing an excessive contraction of economic activity

The dilemma between relaxing or continue tightening could only be solved with more information, as time goes by, but postponing necessary decisions could threaten economic stability.

This is a hard time for policymakers

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