Box 2
Determination of the Monetary Policy Stance

Under the inflation targeting plan, currently at 3.0% per annum, *Banco de la República* sets an interest rate, known as the monetary policy interest rate (or MPR) At this rate, it is willing to offer unlimited amounts of overnight liquidity to all entities qualified as eligible to be its counterparty.

When inflation and its expectations deviate from the target and/or economic activity deviates from its sustainable level, *Banco de la República* modifies the monetary policy interest rate (MPR). For example, when economic activity collapsed in the second quarter of 2020 and fell well below long-term sustainable levels, the Bank played an important role in the countercyclical response implemented at the time. This included monetary policy and initiatives in the fiscal area, banking regulation, and financial supervision parameters, all designed to alleviate the effects of the shock on markets, businesses, and households. In this context, the MPR went from 4.25% before the pandemic to 1.75% a few months after.

Having overcome the difficult circumstances of the time, macroeconomic policy in general, and monetary policy in particular, they must now face the challenge of normalizing the use of their economic policy instruments and doing so in an orderly but systematic manner. There were two factors that should have been considered at the end of 2021. First, not recognizing that many of the instruments are far from the levels they exhibited before the pandemic. Second, the remoteness of instruments such as public debt and the MPR from their pre-pandemic levels is occurring in a context of very high growth of both domestic demand and inflation, and constitutes risks to macroeconomic stability, which need to be countered.

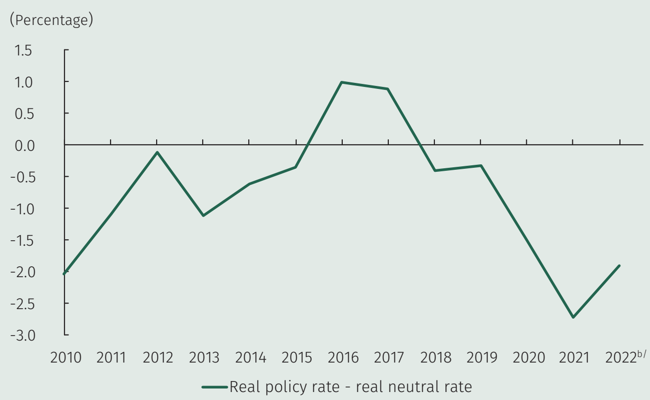
In this regard, the Bank has been immersed in a process that seeks to normalize the monetary policy stance by raising the MPR since the last quarter of 2021 and after the highly atypical situation required by the difficult circumstances faced by the economy.

The adjustments to the MPR that the Bank has been implementing in the economic contraction phase of 2020 and the current normalization phase influence other longer-term interest rates. These longer-term interest rates, in turn, change the behavior of businesses and households. In the current phase of normalizing the monetary stance, for example, there is a tendency for their willingness to save to increase and their willingness to borrow to finance higher spending flows to decline. If, as is currently the case, there is a significant excess of aggregate demand to national supply, what is certain is that several things are coinciding. First, the country is increasing its levels of indebtedness to finance this excess demand, a factor that, unless there is a change at some point, may jeopardize future macroeconomic stability. Second, excess demand, in the midst of ample liquidity and credit availability, adversely affects the inflationary process and there is a danger that this will end up being reflected in nominal contracts and make a future reduction in inflation much more costly. Third, in the short term, it is not reasonable to think that aggregate supply adjustments of the magnitudes required to offset this current excess demand will arise: for one thing, there are problems related to supply chains that make it difficult to adjust supply in the short term. But there are also more structural problems that will affect our future productive capacity. For example, the lagging of private investment, employment, labor participation, and productivity.

An intuitive way to measure the monetary policy stance (the degree to which it is expansionary or contractionary) is to compare the MPR in real terms (i.e. correcting for inflation) with the so-called neutral interest rate. The latter is the rate that would prevail in a macroeconomic situation that has two characteristics: 1) economic activity grows steadily at the same rate as its potential rate, i.e., the output gap is zero, and 2) inflation is stably located at the established target level. Based on this definition, when the MPR is below the neutral rate, the monetary policy stance is understood to be expansionary. When both rates coincide, the monetary policy stance is neutral.

Graph B2.1 shows an estimate of Colombia's monetary policy stance for the period 2010-2022 in annual terms. As can be seen, the monetary policy stance would have typically been expansionary over the last twelve years and continues to be so well into 2022 in spite of the normalization process that began at the end of 2021.

Graph B2.1
Monetary Policy Stance in Colombia 2010-2022[a/]



a/ There are multiple ways to estimate a real interest rate when starting from the nominal interest rate and subtracting various inflation expectation measurements. In the particular case of this graph, the annual average of inflation expectations for the twelve-month period from the Monthly Survey of Economic Analysts' Expectations (latest cut-off in February 2022) were discounted from the annual average of the nominal policy interest rate. The real neutral rate corresponds to the one published in the January 2022 *Monetary Policy Report*.
b/ The calculation for 2022 uses the MPR defined by the Board of Directors of *Banco de la República* in January 2022 and that remains in effect for February.
Source: *Banco de la República*; authors' calculations.

The monetary policy normalization process is part of a broader need for macroeconomic policy in general and includes the fiscal and financial regulation components. Therefore, it is necessary and desirable that these processes be harmonious.

The major changes that were made on the financial regulatory and supervisory front as the pandemic crisis began in the second quarter of 2020[1] were of great importance to giving indebted businesses and households relief without unduly compromising the soundness of the banking system. These decisions have been reversed and the system is now operating under normal conditions.

On the monetary front, Colombia's monetary stance, as has been seen, has begun its normalization process and, going forward, harmony with the equally necessary process of fiscal policy normalization will be crucial. This challenge, which is common to many developed and emerging countries in the post-pandemic period, requires that the sequence of fiscal measures that the country will have to adopt in order to achieve a trajectory consistent with the sustainability of public finances, once the countercyclical process required by the pandemic has been overcome, be shown clearly, simply and credibly.

The effects of a change in the monetary policy stance are smooth when there is harmony between monetary policy, financial regulatory policy and fiscal policy. If, on the contrary, the future of public finances is uncertain, such effects are less smooth and may become very disruptive.

First, because in such an environment the financing of the public deficit tends to become more difficult, and this would mean raising the interest rates applicable to the various financial instruments issued by the government. This, in turn, constitutes a new adverse fiscal shock that deepens the initial uncertainties.

Second, because as interest rates rise, the prices of these debt instruments fall. Since public debt instruments have a very significant representation in the total basket of outstanding financial assets, the value of this basket could suffer a significant deterioration, even if the other assets in the basket were not affected. To the extent that this basket is a crucial part of the assets belonging to households (for example, through their pension savings), companies and credit institutions, and eventual asset impairment may jeopardize future macroeconomic stability.

Third, because, as has happened internationally on many occasions, fiscal uncertainty may generate inflationary processes at some point. This is the case, for example, of countries that, unable to reduce public deficits and facing difficulties in accessing sources of credit for their respective governments, choose to finance the fiscal deficit by issuing money. This generates an excess of money supply which, in turn, causes inflationary processes that are sometimes of great magnitude. Even if the central bank does not monetarily finance the deficit, i.e., even if the nominal money supply is constant, fiscal uncertainty may imply a fall in the demand for money by households and firms, for example, by substituting alternative currencies for local currency. This depreciates the exchange rate and raises the general price level.

Fourth, because the fiscal deficit, in itself, is a use of foreign financing. That is, the balance of payments current account deficit (what the rest of the world lends to the country each year) is the source while these flows are used to finance the private deficit, on the one hand, and the public deficit, on the other. In this respect, fiscal uncertainties may turn into adjustments in the willingness of the rest of the world to finance the country's current account as a whole, and the consequent need to adjust private spending very rapidly and in a disorderly fashion with significant effects on economic activity and welfare.

1 Circulars 07 and 014/March 2020 authorized temporary grace periods which benefited 11.8 million debtors. The loans they had amounted to COP 225 billion and represented 42.4% of bank credit and were the obligations currently under ordinary regulation. In the second stage, the Debtor Assistance Program (Programa de Acompañamiento a Deudores, PAD) was created, effective for one year as of July 2020, to facilitate agreements with debtors consisting of loan restructurings, provided that the necessary provisions were made to cover the estimated risks, a mechanism that covered loans for COP 37 trillion (6.8% of the portfolio). These obligations are being repaid, and as of December 2021, they totaled COP 28.4 trillion.