The Inflation Targeting Strategy in Colombia

OBJECTIVES

Monetary policy in Colombia is based on inflation targeting, which is mainly intended 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 inflation forecast 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 that the deviation would not be due to temporary shocks, the BDBR modifies its policy stance. This is accomplished mainly 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 the 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

The consumer price index (CPI) registered an annual increase of 5.93% in March 2008. This surpasses the rate witnessed the quarter before and is 143 basis points (bp) above the top of the inflation-target range for 2008. Nearly half the CPI build-up (45%) during the quarter was due to higher food prices, particularly for foods affected by the increase in international commodity prices.

Non-food inflation in March 2008 (4.67%), which was up by 24 bp with respect to December 2007, explains the other 55% of the rise in inflation during the quarter. Most of this increase originated with hikes in the price of regulated goods and services, particularly the spike in fuel prices and, to a lesser degree, the adjustment in rates for public utilities such as water and electricity.

There were, however, other factors that suggested the presence of inflationary pressure, mostly due to the momentum in local demand. They are described below.

1. The various core inflation measurements, which leave out the price of goods and services affected by temporary supply shocks, while including those affected by monetary policy measures, remained high throughout the first quarter of 2008 and showed no signs of declining.

2. Non-tradable inflation without food and regulated prices, which is determined largely by the force of local demand, declined between January and March 2008, but continued to exhibit annual rates above the target range for inflation this year.

3. The Colombian peso appreciated 14% (annual average rate) during the first quarter of 2008. This situation was accompanied by a major influx of foreign direct investment, mostly in oil and mining, with specific investments in companies in other sectors. However, revaluation of the peso is not been reflected in less inflation in goods and services that

are affected by the exchange rate. In fact, the first quarter saw a slight upward trend in tradable inflation, excluding food and regulated prices.

4. The increases in gross domestic product (GDP) (8.1%) and local demand (10%) during the fourth quarter of 2007 far surpassed the Bank's forecasts and the market's expectations, and continue to outpace growth in the productive capacity of the economy. The accumulated increase in real GDP was 7.5% in 2007. Growth in demand eased somewhat between the first and third quarter of last year, but accelerated in the fourth quarter due to the added momentum in investment and consumption.

5. As to the first quarter of 2008, the figures on economic activity show that aggregate demand has slowed, but remains robust. Between January and March, the average Fedesarrollo consumer confidence indicator was close to the average registered in 2007. By February 2008, commercial retail sales had experienced a sizeable increase (6.9% in real terms) and imports of consumer goods also registered high growth rates.

6. On the supply side, industrial growth rates remained low in February 2008, but registered an annual variation above their historic average (even when the 1999 recession is excluded from the average). The indicators of installed capacity continued to slow, but are still high and close to those reported at the start of 2006. The inventory, order-volume and industrial-confidence indexes show signs of a moderate slowdown, but are still at favorable levels.

7. The inflation expectations implicit in government debt paper rose during the first two months of 2008, before declining sharply in March and early April. However, the level of this indicator and that of expectations reported in various surveys remained above the target for inflation.

8. Monetary aggregates declined between January and March of this year, following an upward trend during the last quarter of 2007. Nevertheless, the annual expansion in base money and the broader monetary aggregate (M3) continued to exceed the nominal increase in GDP estimated for the current year. March witnessed the continuation of more moderate growth in local currency loans, primarily due to less of an increase in the retail loan portfolio.

9. Nominal lending and deposit rates continued to climb during the first three months of the year. In real terms, interest on preferential loans was above its historic average, while total interest and interest on retail and ordinary loans was near or slightly below average.

10. On the external front, the news in late 2007 and early 2008 signaled the possibility of a slowdown in the United States economy during the first quarter of this year. The latest information suggests the slowdown in GDP in the US might not be as pronounced as was anticipated at the start of the year. However, the crisis in the financial system and the increase in risk levels and restrictions on credit indicate the United States economy may be in for a longer period of low growth, including 2009. Commodity prices remained high, bringing inflationary pressure to bear on that country's economy. Given this outlook, the markets expected less of a decline in the interest rate set by the US Federal Reserve Bank and forecast a possible pause at around the 2% level.

11. The large emerging economies, such as China and India, which require an enormous amount of commodities, continued to report high economic growth rates. Coupled with other factors (such as the increased demand for bio-fuels), this has helped to maintain the upward trend in international prices for a number of commodities exported by Colombia (oil, coffee, coal, gold).

Considering all these factors, Board of Directors raised the Central Bank's benchmark rate by 25 bp in February and held it steady at 9.75% in March. That same month, the Board also decided to purchase foreign exchange through auctions of put options to accumulate international reserves. This decision was in response to the uncertainty derived from the world economy. These auctions will be held monthly with a quote of US$150 million, which means US$1.8 billion can be acquired in one year through this mechanism. The Board will continue to keep a close eye on the international situation, as well as inflation, economic growth and their forecasts. It reiterated that monetary policy in the future will depend on whatever new information becomes available.

Board of Directors
The Central Bank of Colombia