



# Monetary Policy Challenges: Colombia

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Central Bank Governors, CEMLA, June 5, 2018

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Governor

# Monetary Policy Challenges: Colombia

- Inflation Targeting in Colombia
- Inflation Targeting Outcomes in Colombia
- The System Under Stress
- Policy Challenges

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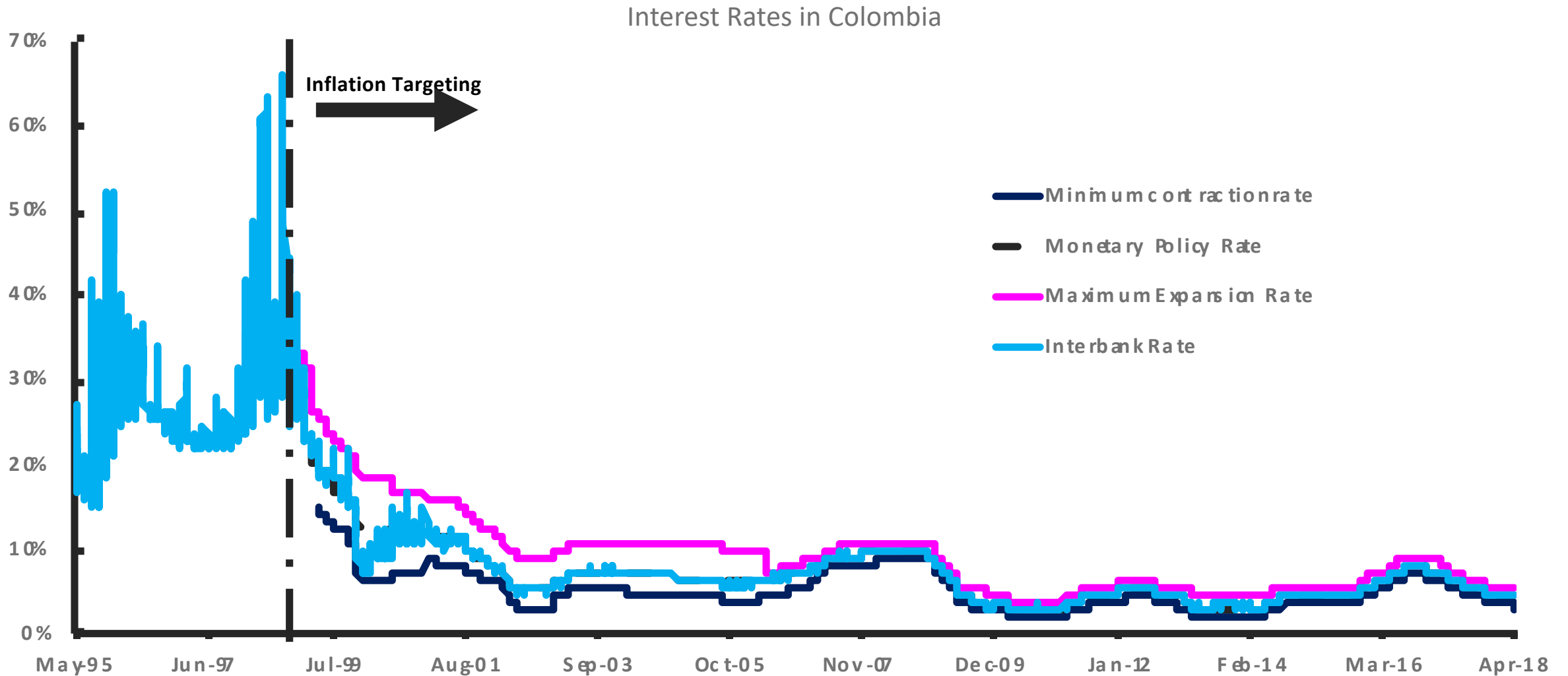
# Inflation Targeting in Colombia: The Two-pillar Approach

Since 1999 the central bank has followed an IT strategy.

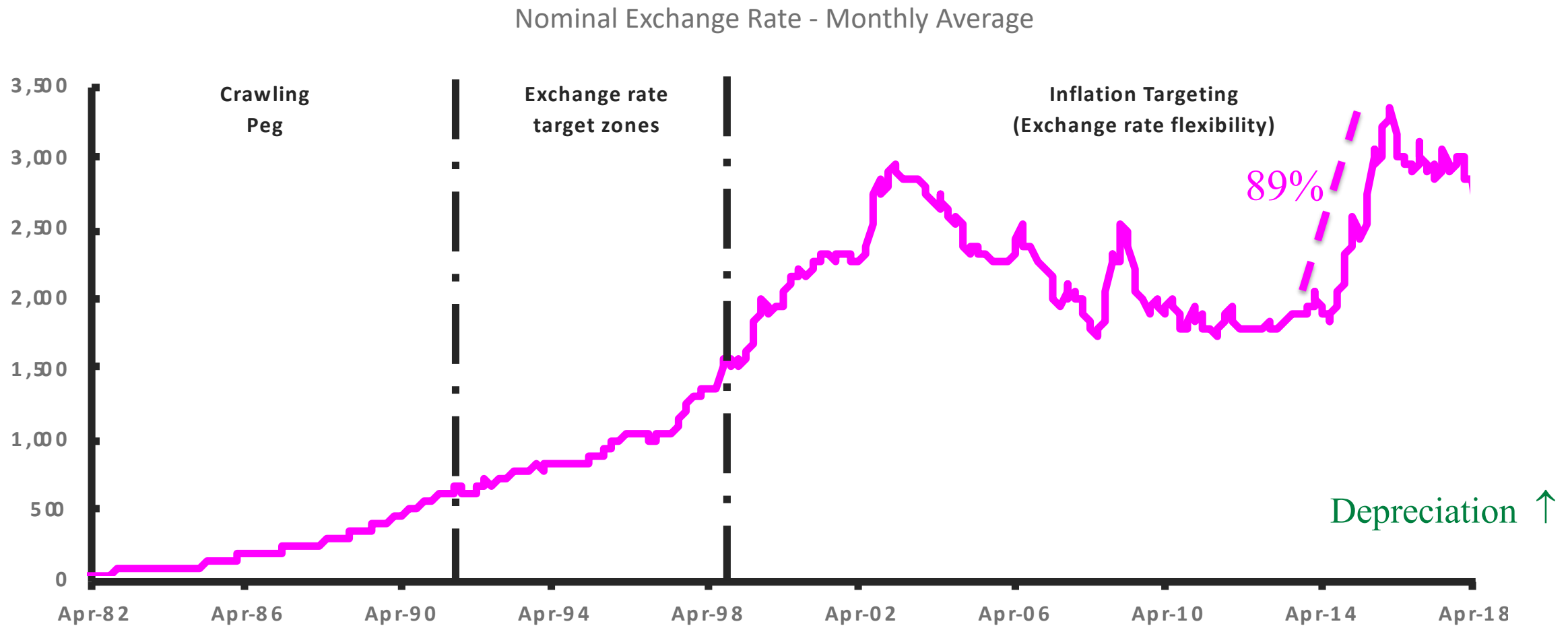
- Pillar 1:  
Low and stable inflation, and short term output stabilization are the primary goals of monetary policy.
- Pillar 2:  
Exchange rate flexibility constitutes an important part of the regime.

# Operational Transparency:

The policy instrument is the overnight interest rate.



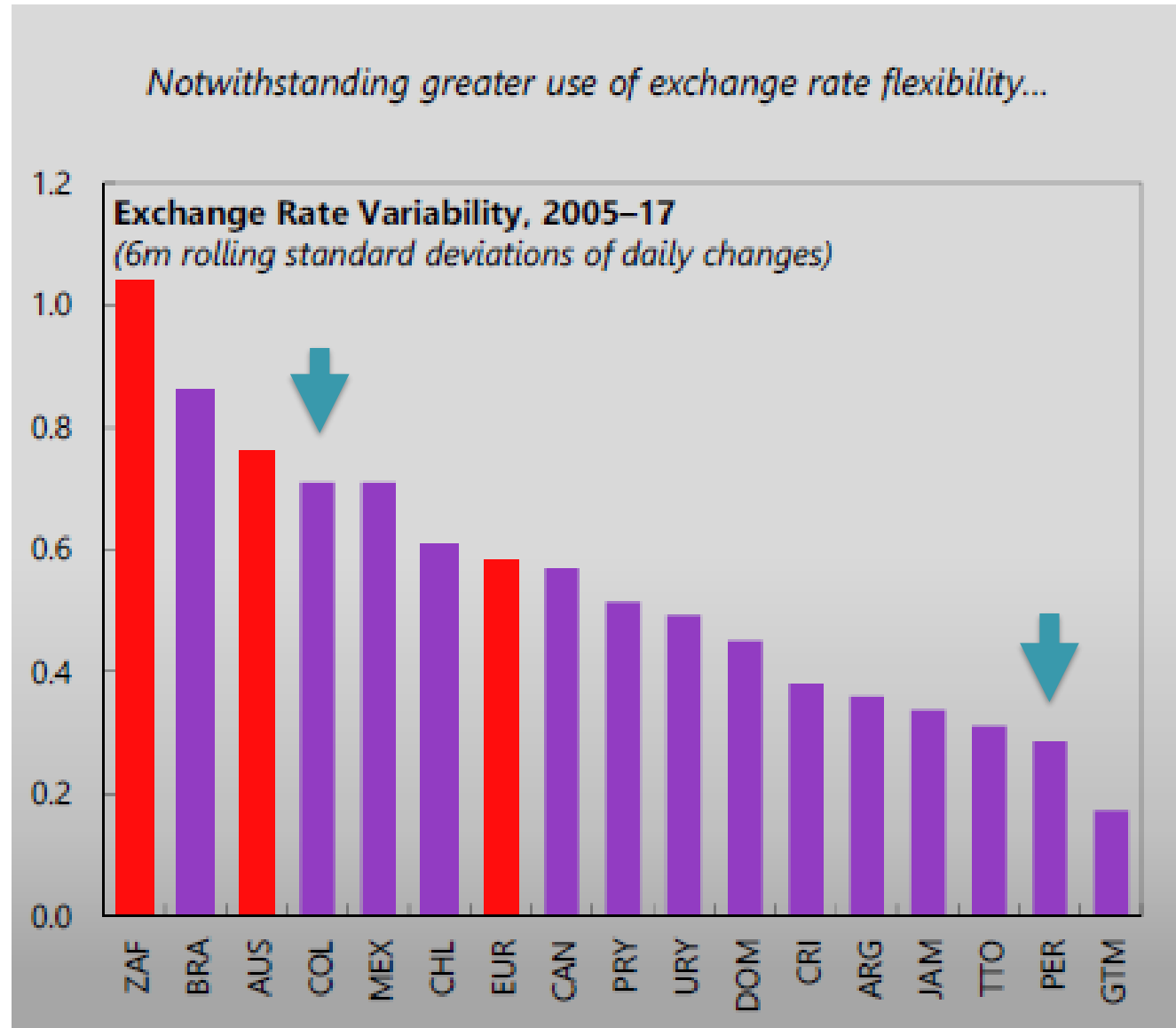
Exchange rate flexibility allowed monetary policy to focus on the inflation target and on short term output stabilization.



Source: Banco de la República

After 1999 there were no explicit or implicit exchange rate targets.

# Exchange rate variability

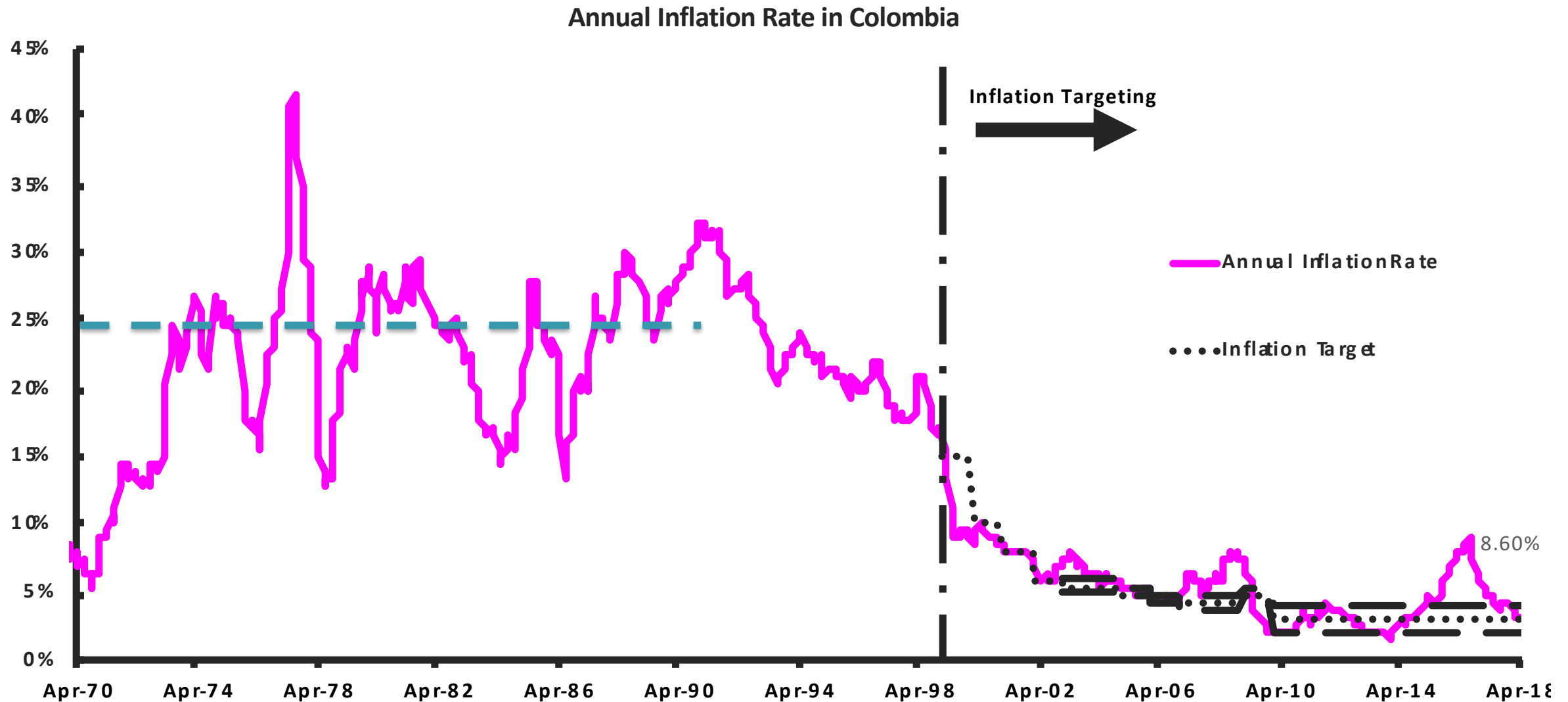


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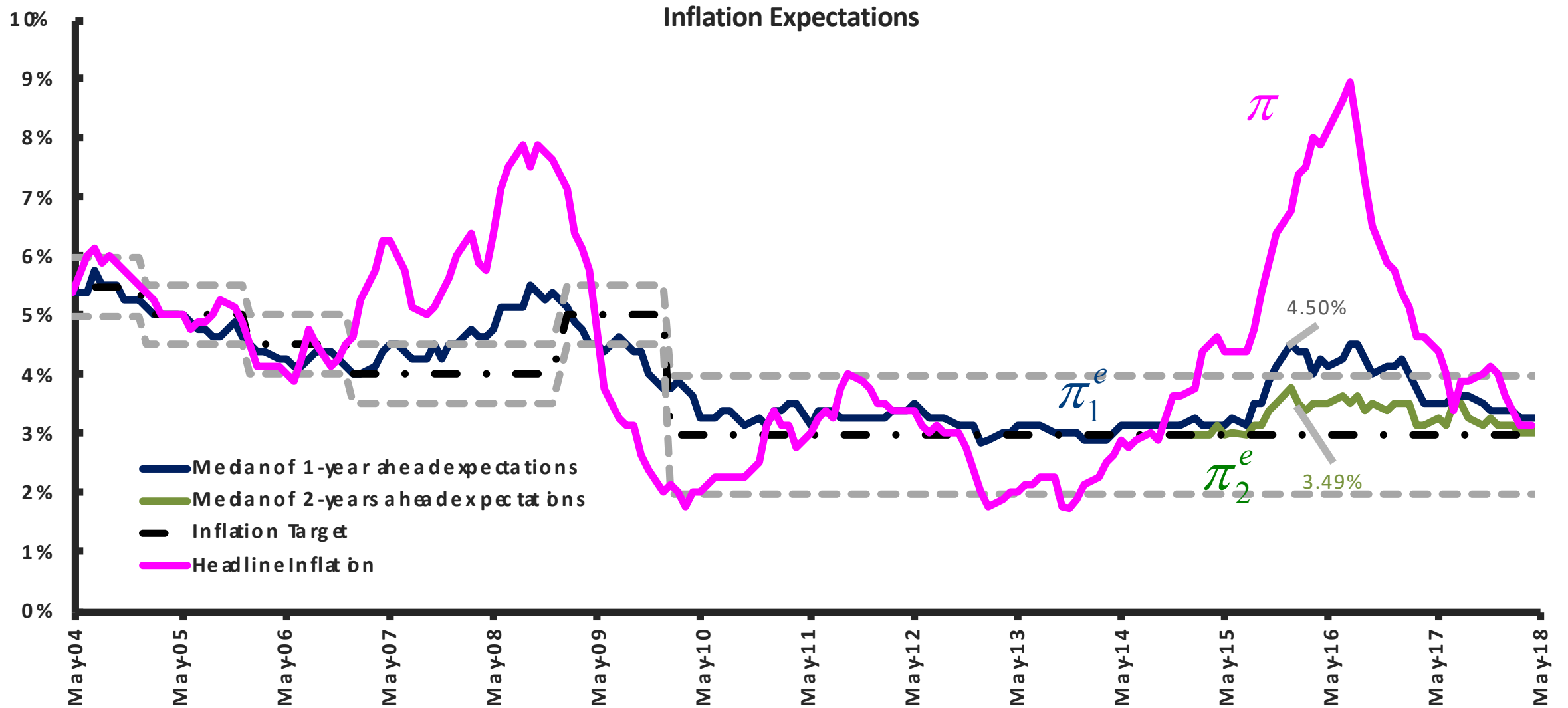


Inflation and its volatility decreased notoriously after the implementation of the IT regime.



Source: Banco de la República

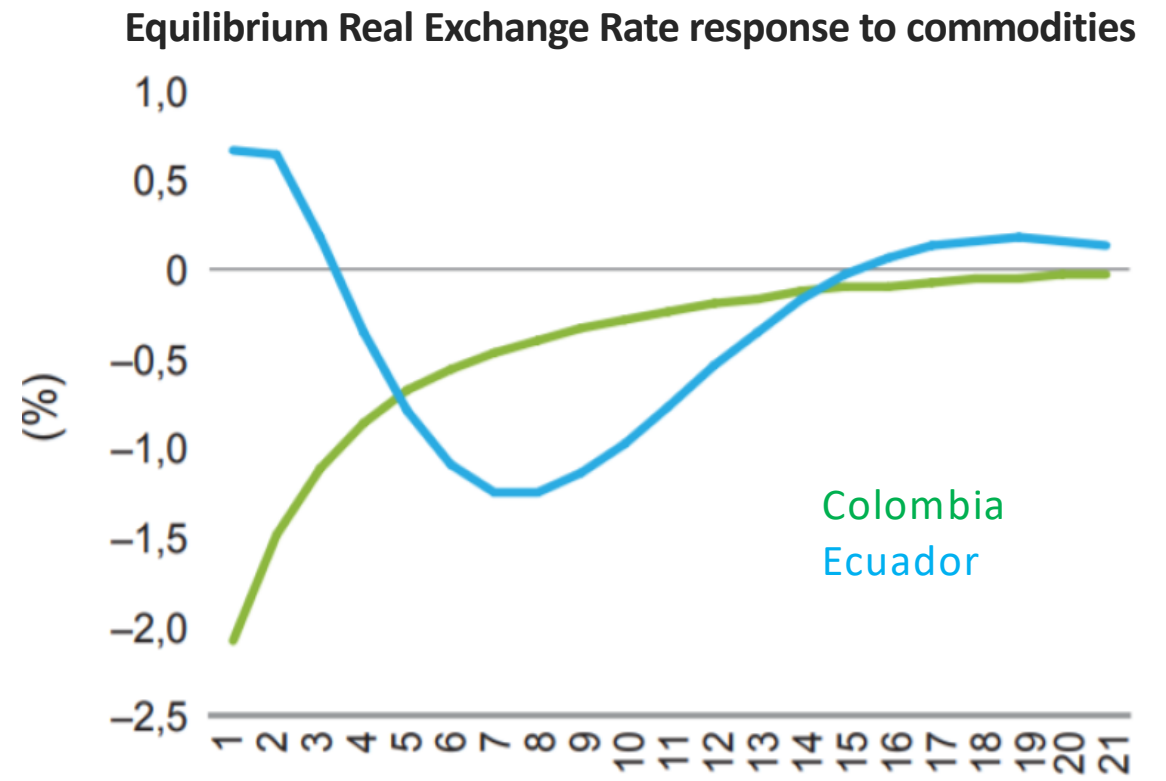
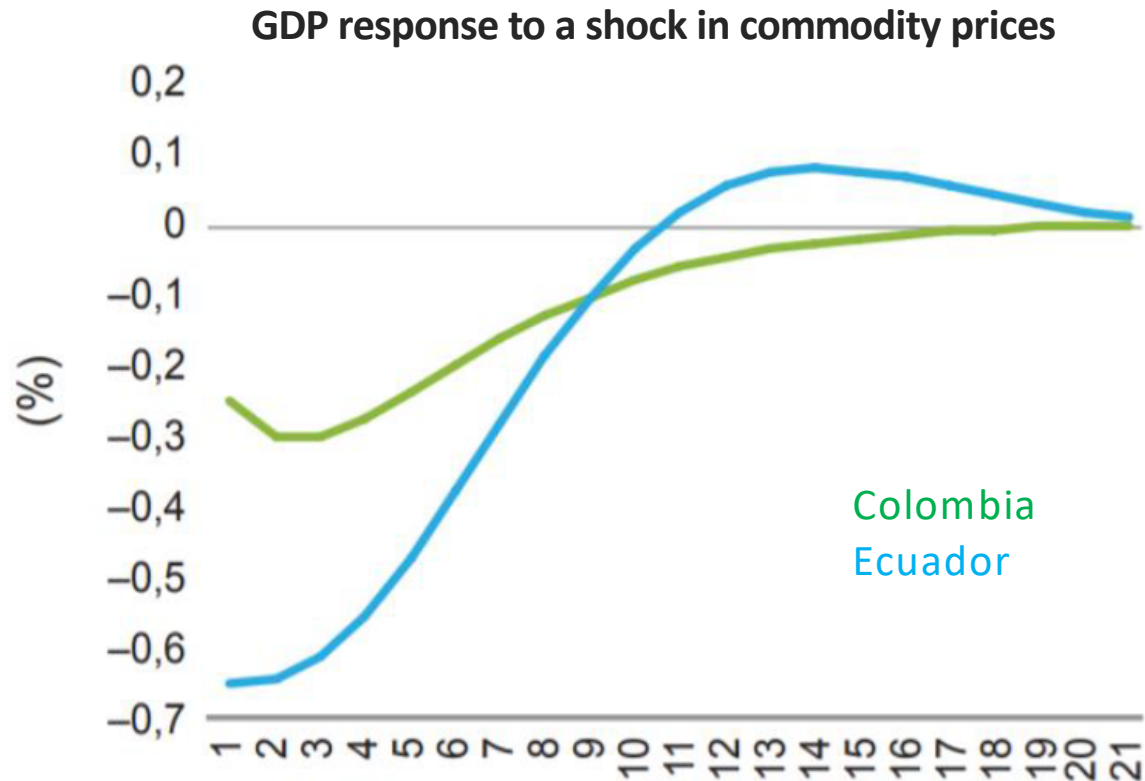
The credibility of the IT regime has kept inflation expectations close to the target even in the face of strong supply shocks.



Source: Banco de la República – Monthly Survey of Economic Expectations

# The Crucial Role of Exchange Rate Flexibility

- Exchange rate flexibility allows for a better adjustment against external shocks.
- For example, oil exports in Colombia and Ecuador are important. However, the response of these economies to a drop in the oil price is different in part because Ecuador is a dollarized economy.



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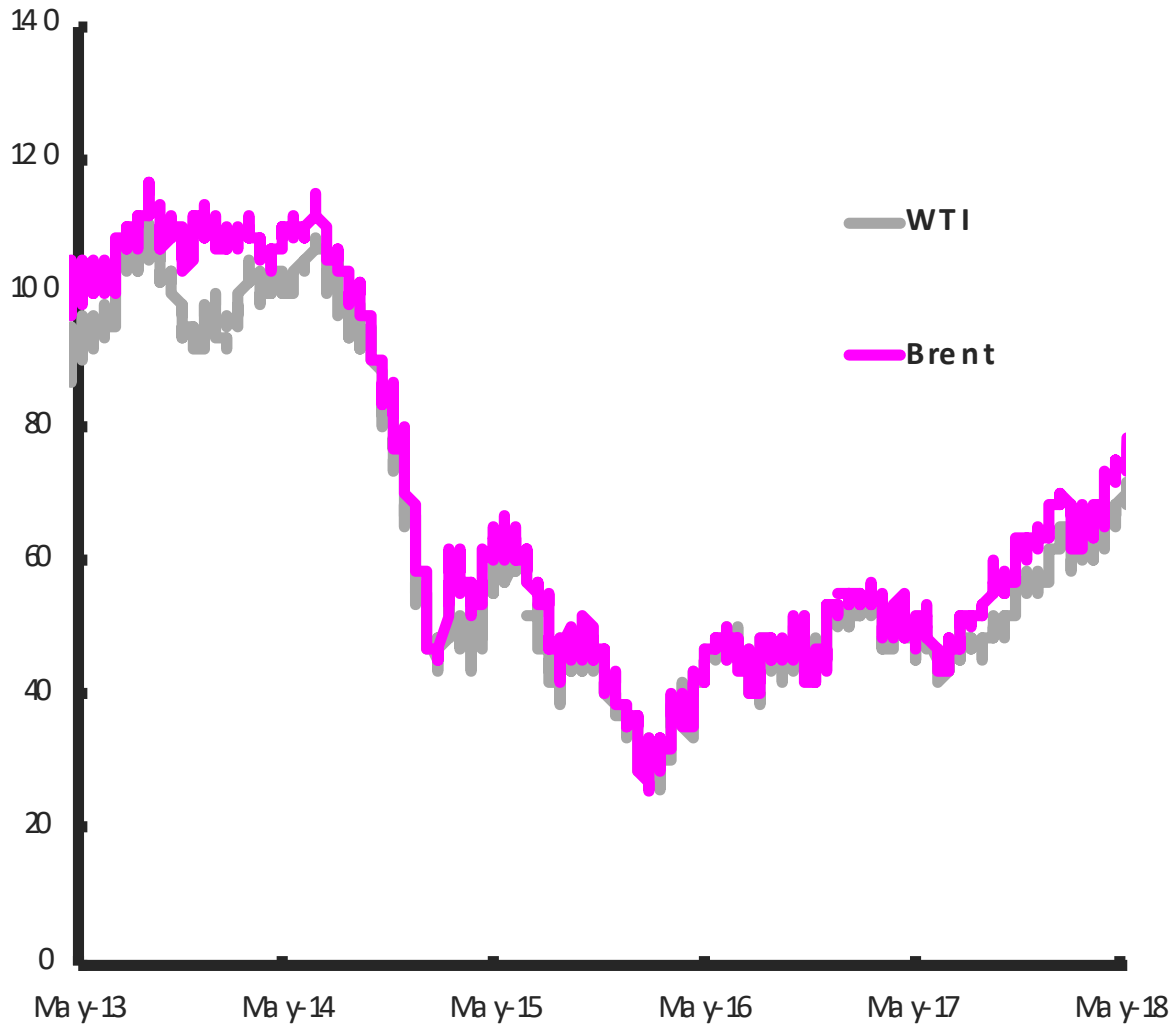
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# The System Under Stress

- Big challenges to the IT strategy emerged between 2014 and 2016 with a succession of shocks:
  1. A drop in oil prices (2014-2016)
  2. Strong El Niño phenomenon and severe droughts (2016)
  3. Truckers' strike (2016)

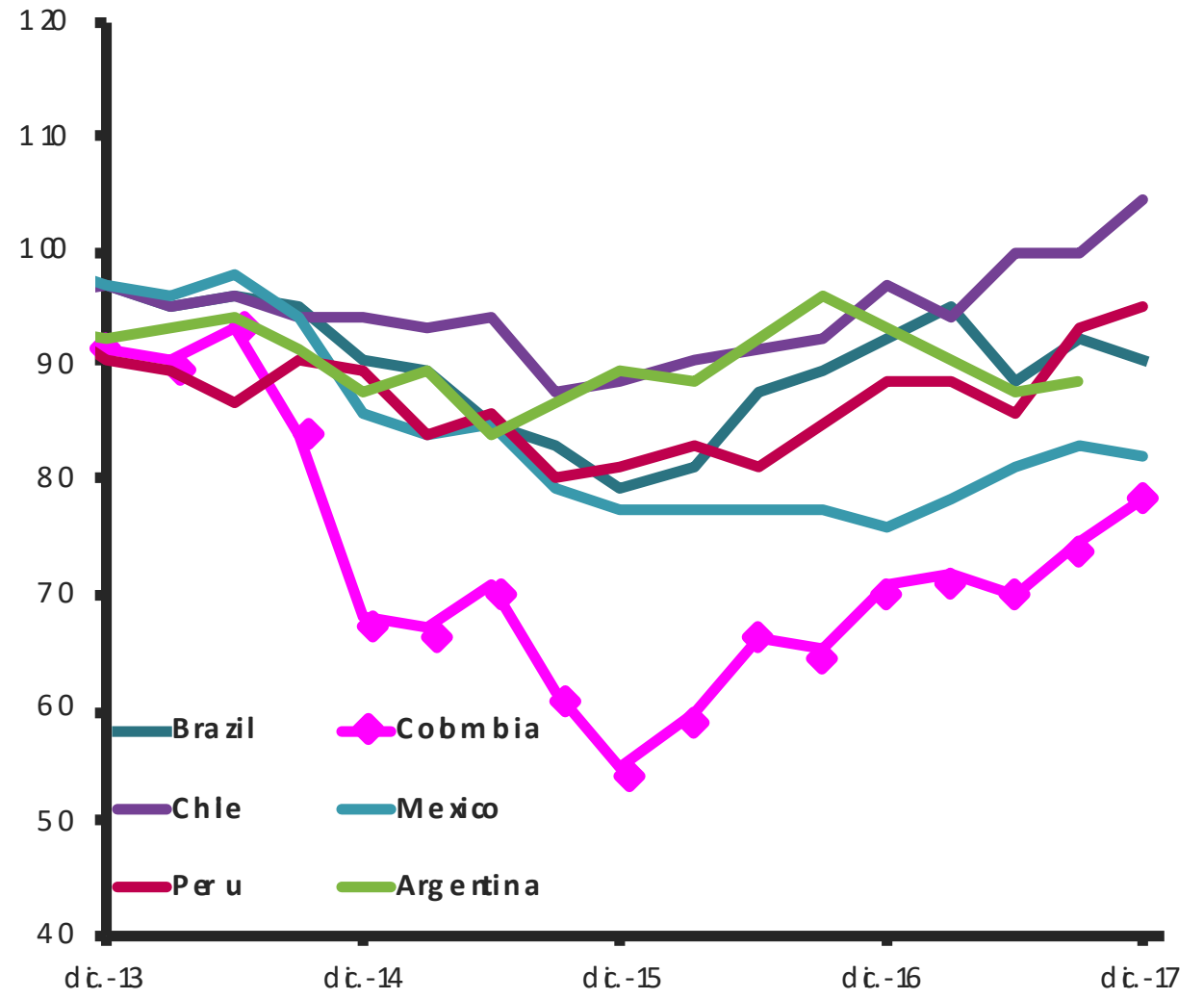
The drop in oil prices hit the economy in 2014 – 2016 deteriorating the terms of trade.

Oil Prices (Brent, WTI)



Source: U.S Energy Information Administration (EIA)

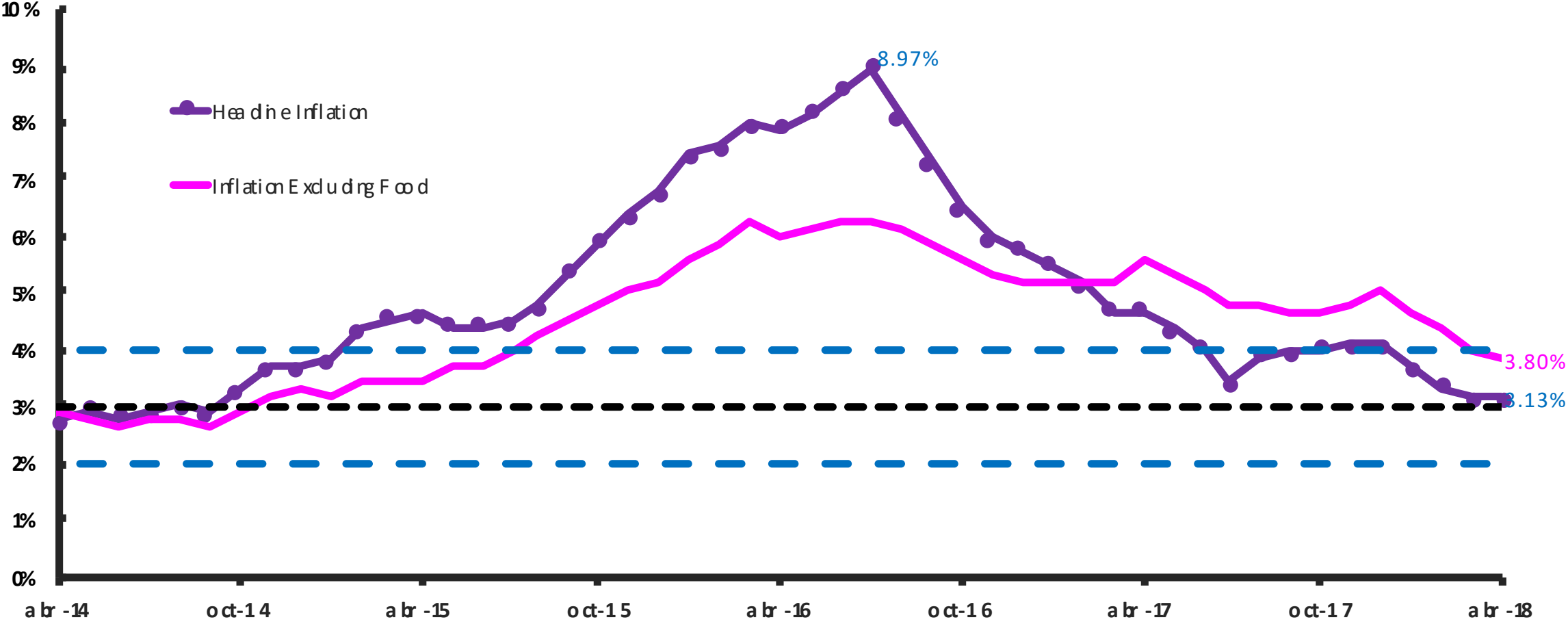
Terms of Trade (2012=100)



Source: Datastream.

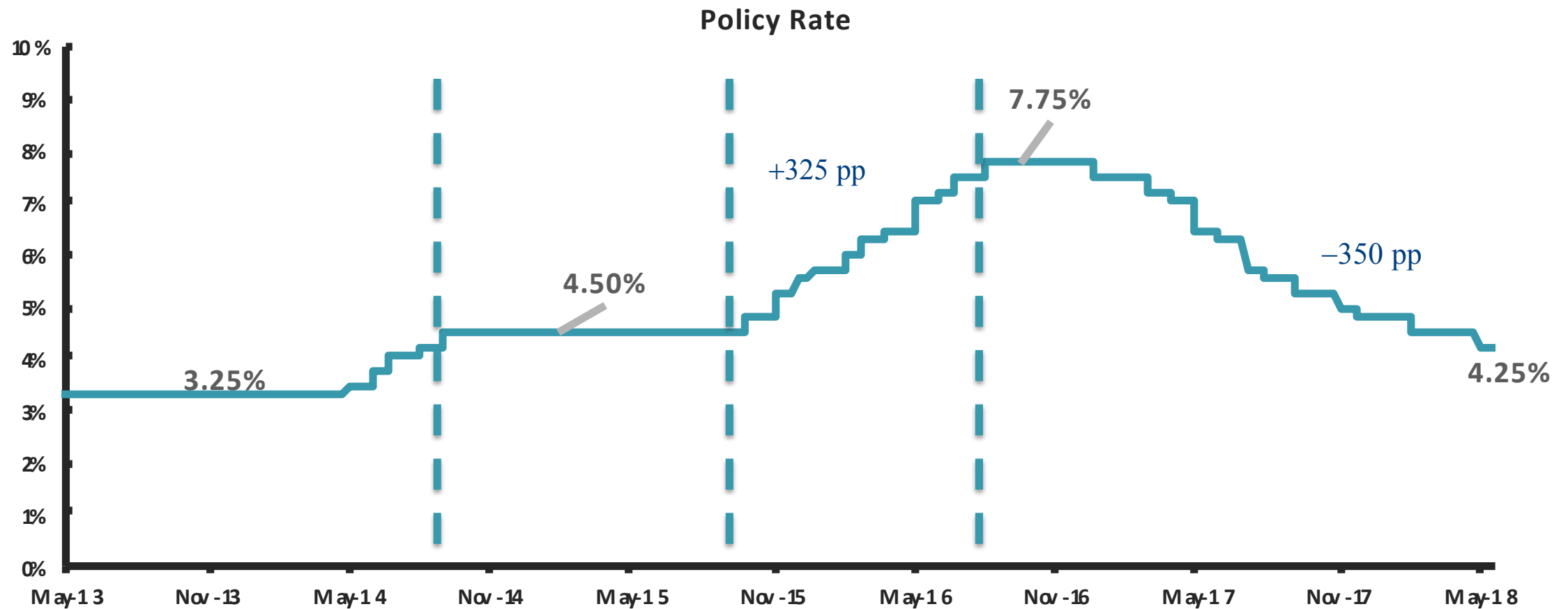
Inflation rose rapidly as a consequence of the depreciation of the currency, together with increases in the prices of food and energy after a drought caused by a strong El Niño phenomenon.

Annual Inflation Rate



Source: DANE. Calculations by Banco de la República.

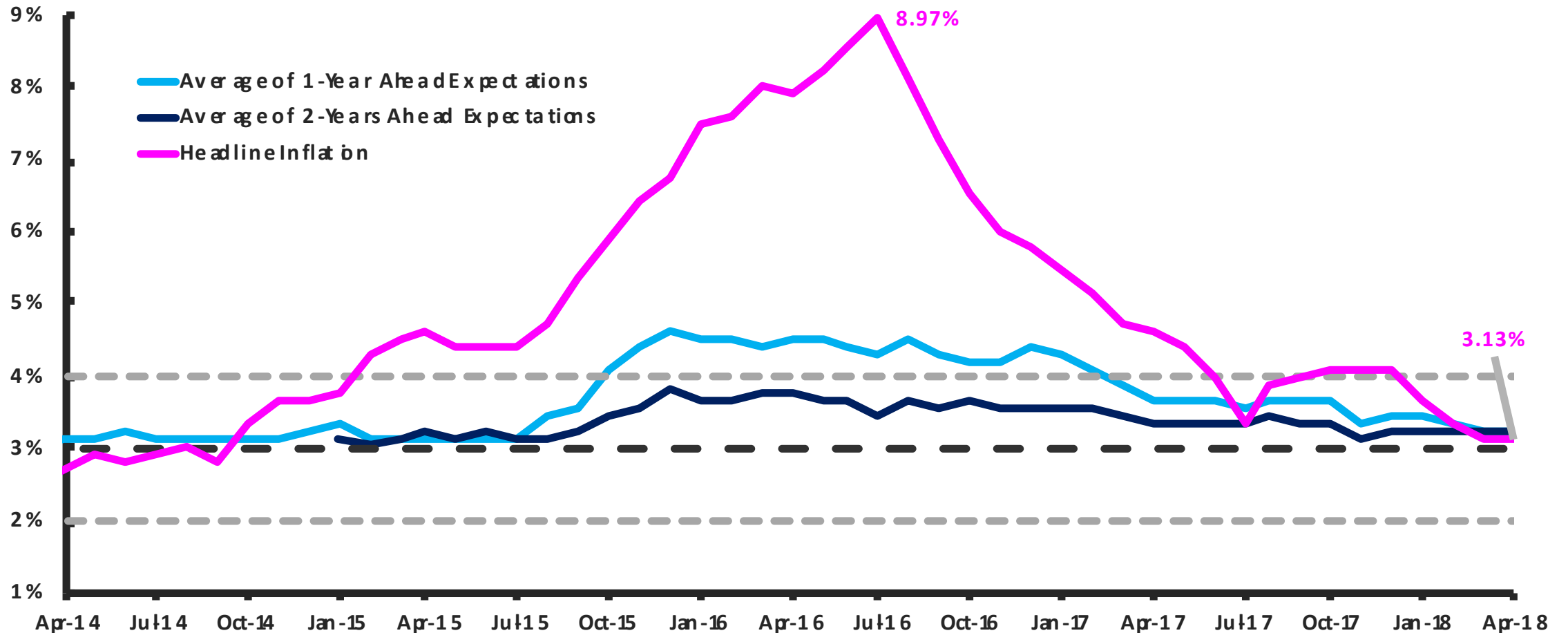
- The size and persistence of these shocks threatened to de-anchor inflation expectations, requiring a tighter monetary policy.
- However, the credibility of the monetary regime, built between 1999 and 2014, allowed a gradual and subdued (relative to the size of the shocks) monetary policy response.





The credibility of the IT scheme allowed a gradual macroeconomic adjustment and the anchoring of inflation expectations.

Inflation Expectations



Source: Banco de la República (Monthly Survey of Economic Expectations) and DANE.

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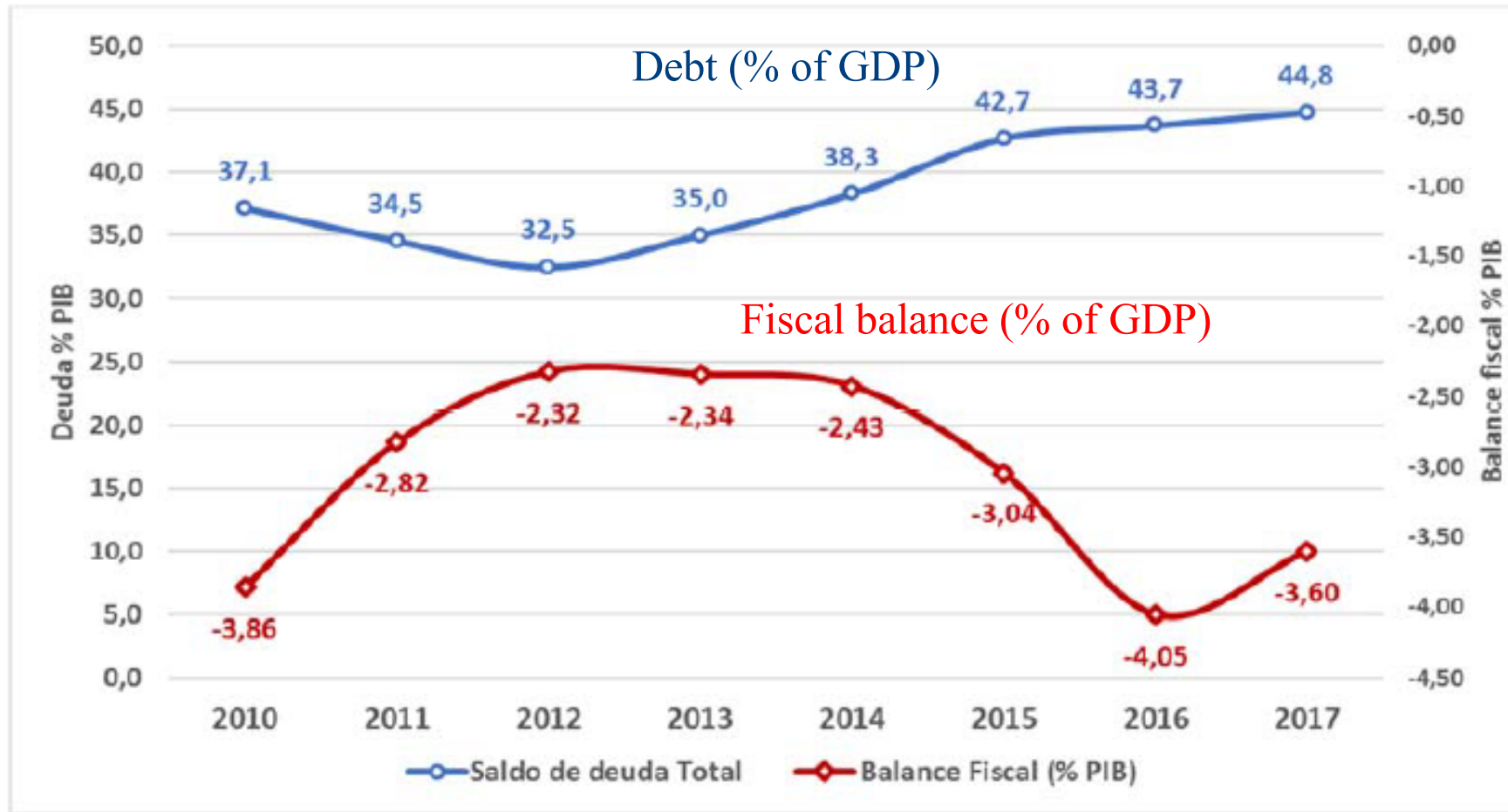
# Policy challenges

- Expectations and policy
- Floating Exchange rates
- Central bank independence
- Fiscal dominance
- Communications and transparency
- Monetary policy rates and other policy instruments

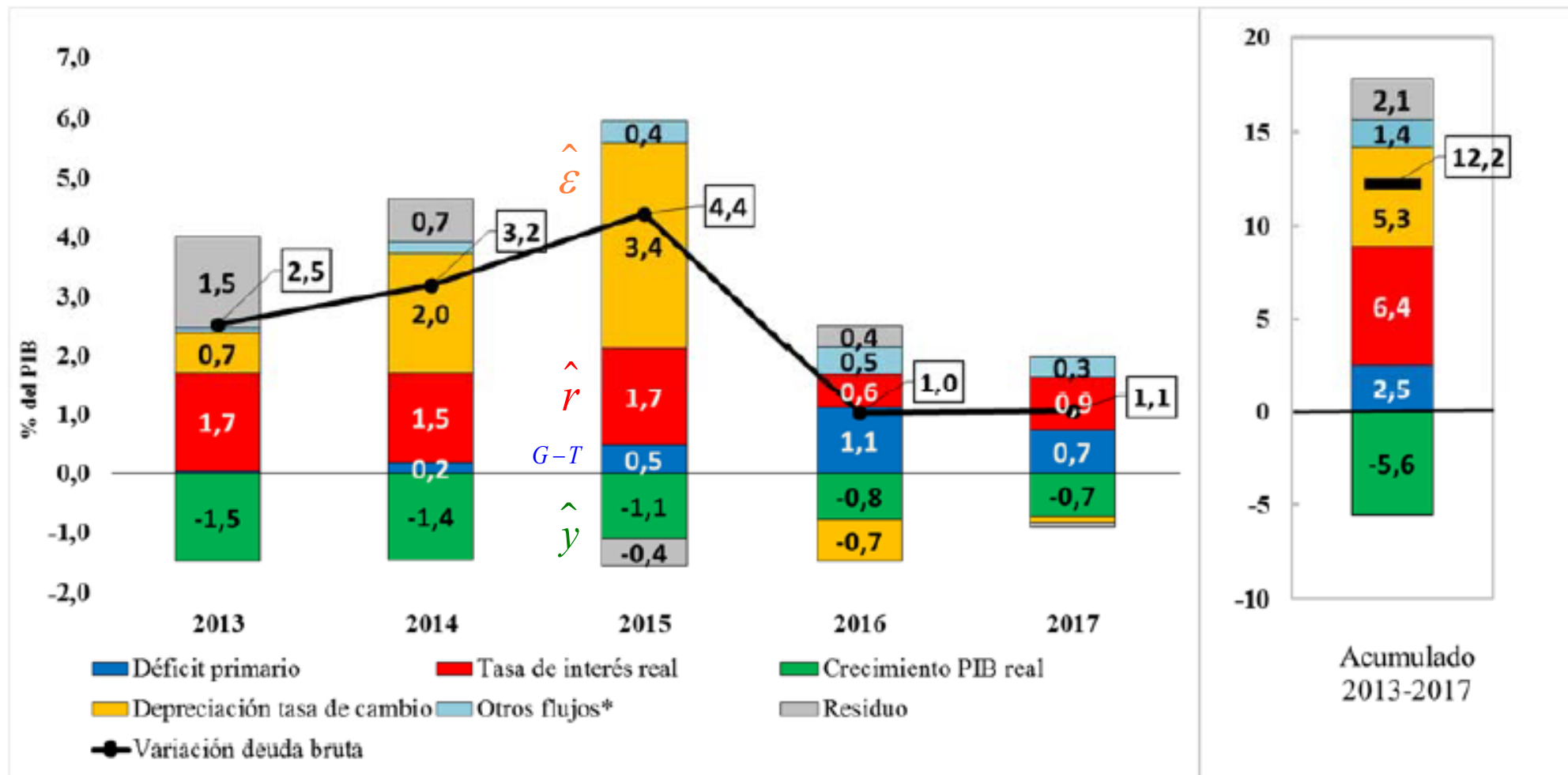
# Central bank independence

- The Governor is appointed by the board
  - Not by the President (congress approval), as in most other countries
- The Minister of finance is a member of the board
  - With vote
  - 1/7 vote...but too much potential “noice”

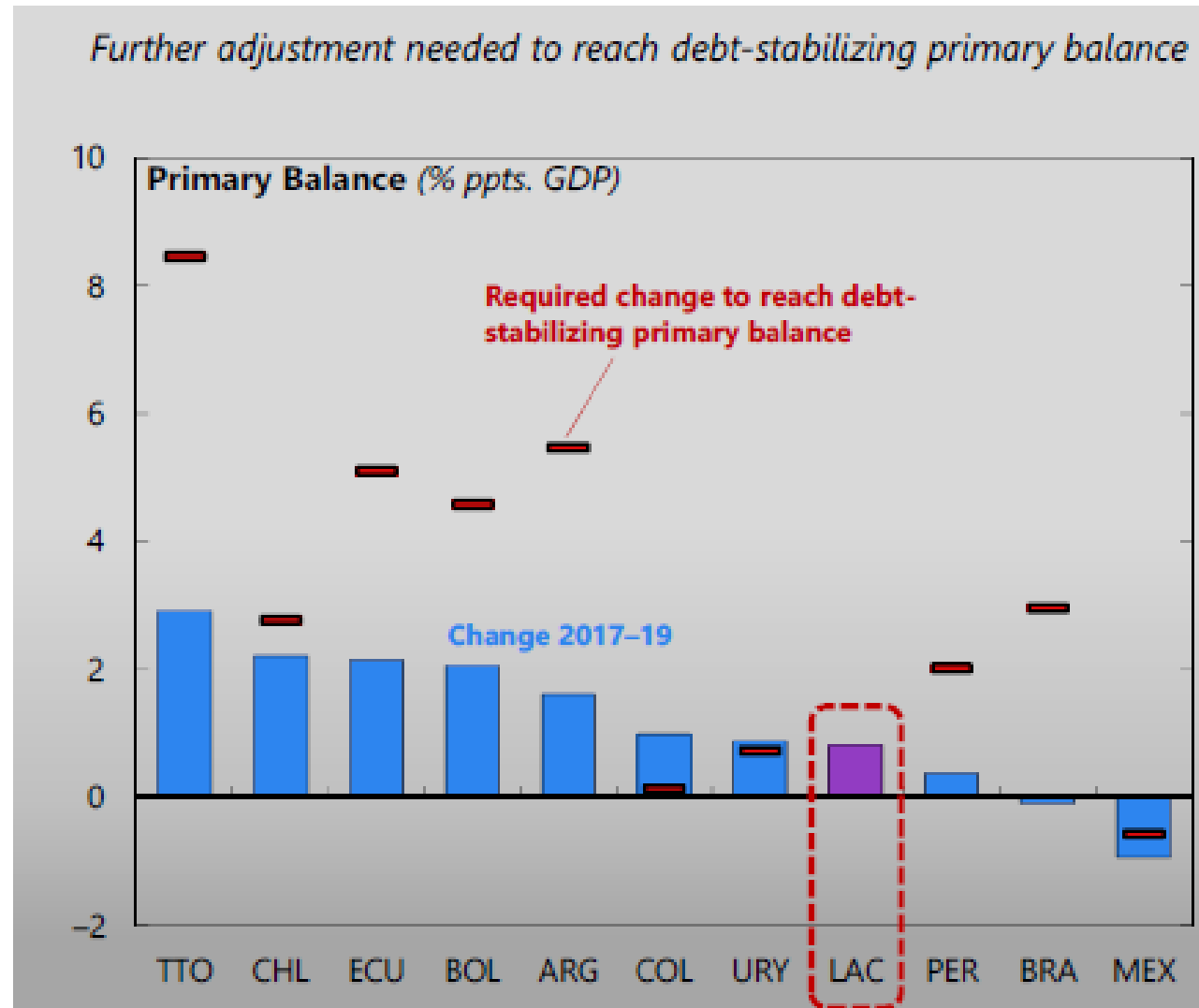
# Fiscal dominance?



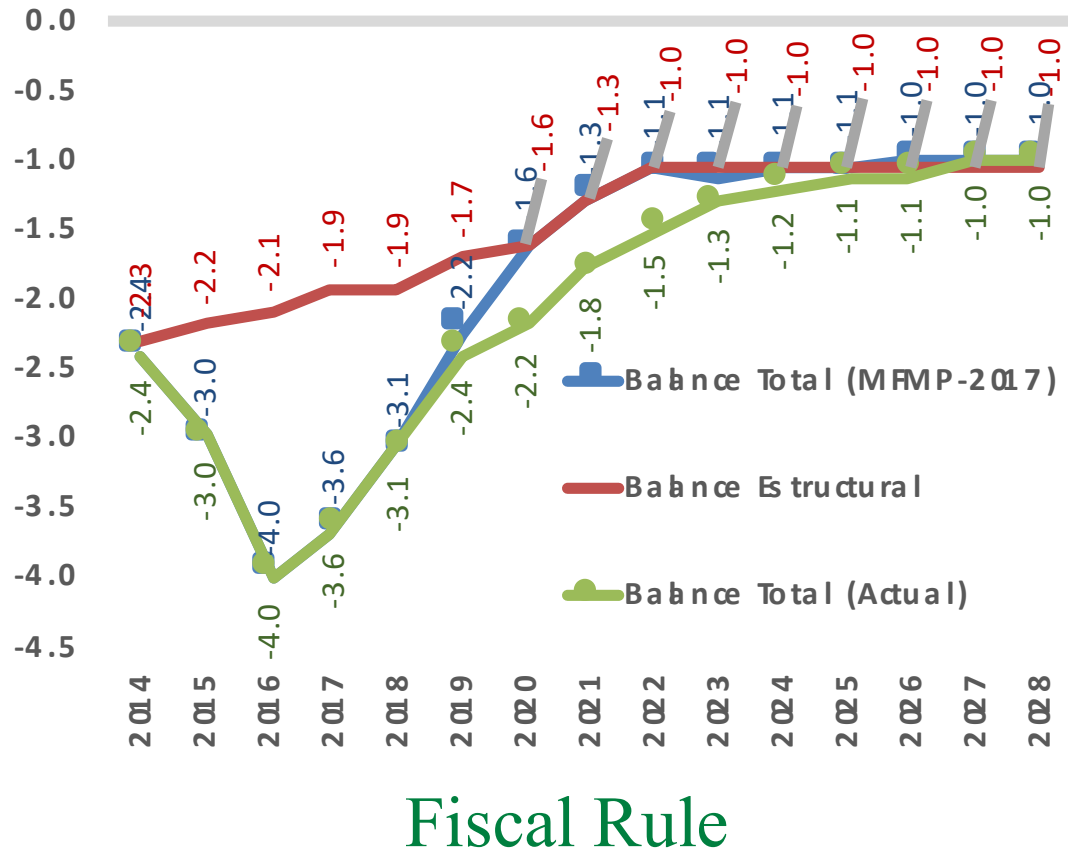
# Fiscal dominance? factors behind larger government debt



# Fiscal dominance? required change to reach debt - stabilizing fiscal primary balance



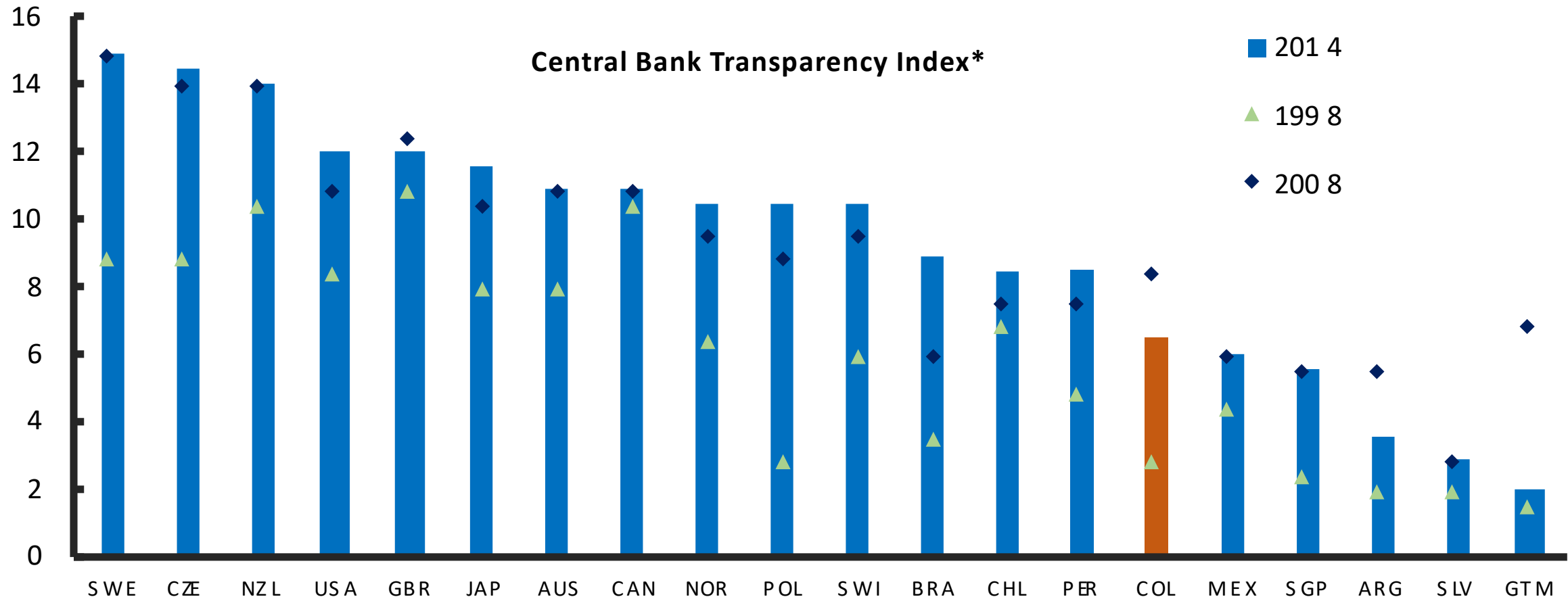
# Fiscal rule and public debt (% of GDP)





# Communications and transparency

Improving communication and transparency is still one big challenge.

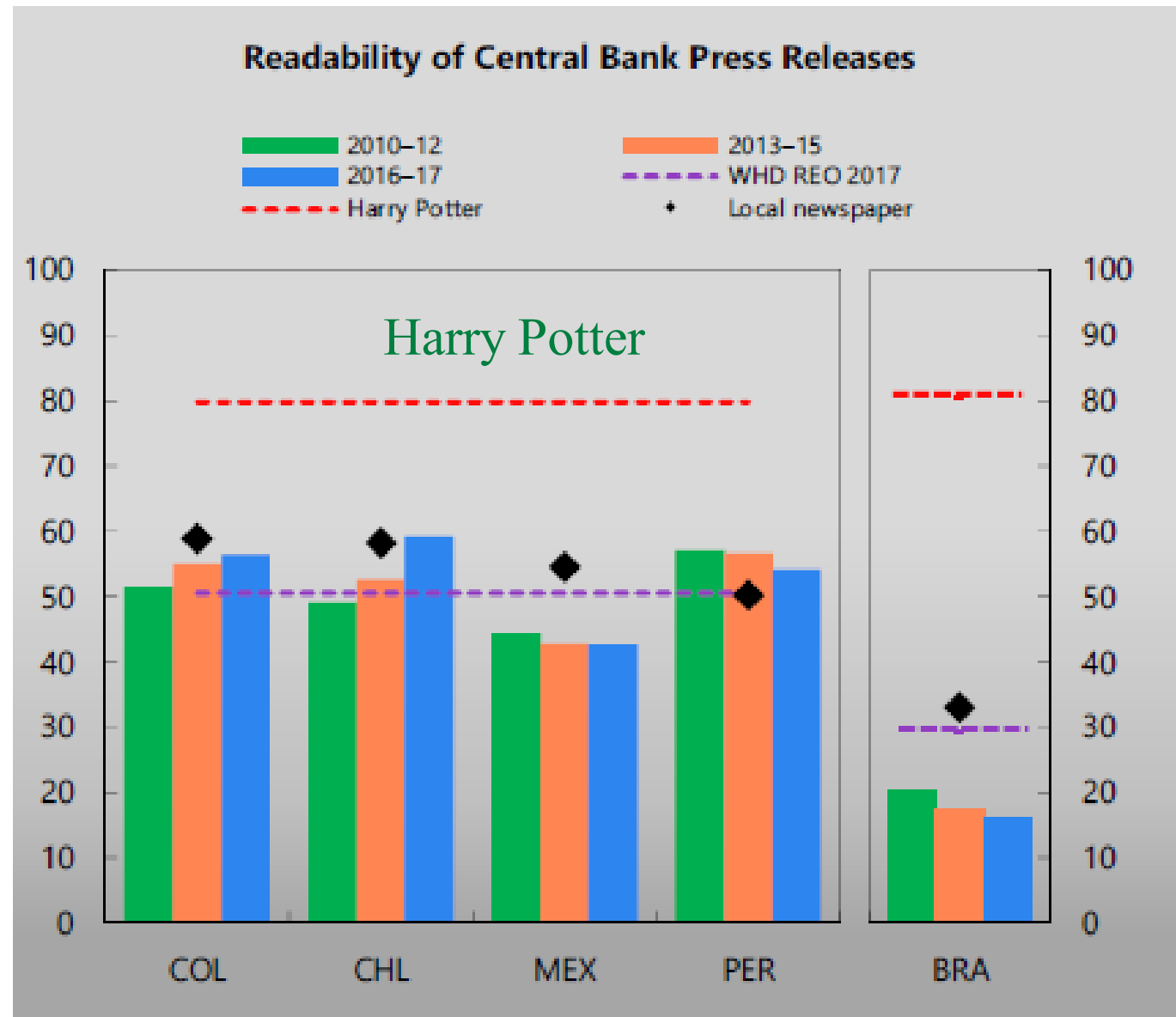


\*The maximum value of the index is 15. The index is built using five categories: Political, economical, procedural, policy, operational. Each category has a value between zero and three.

Source : Dincer and Eichengreen (2014).

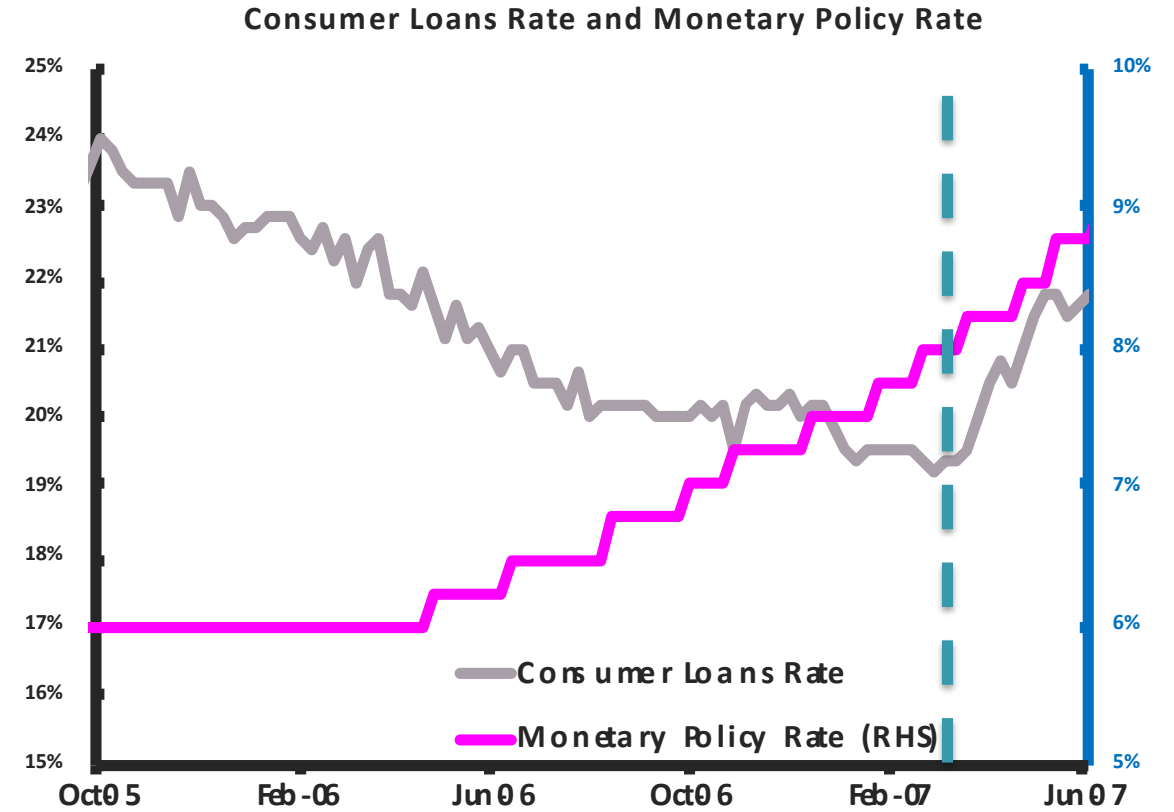
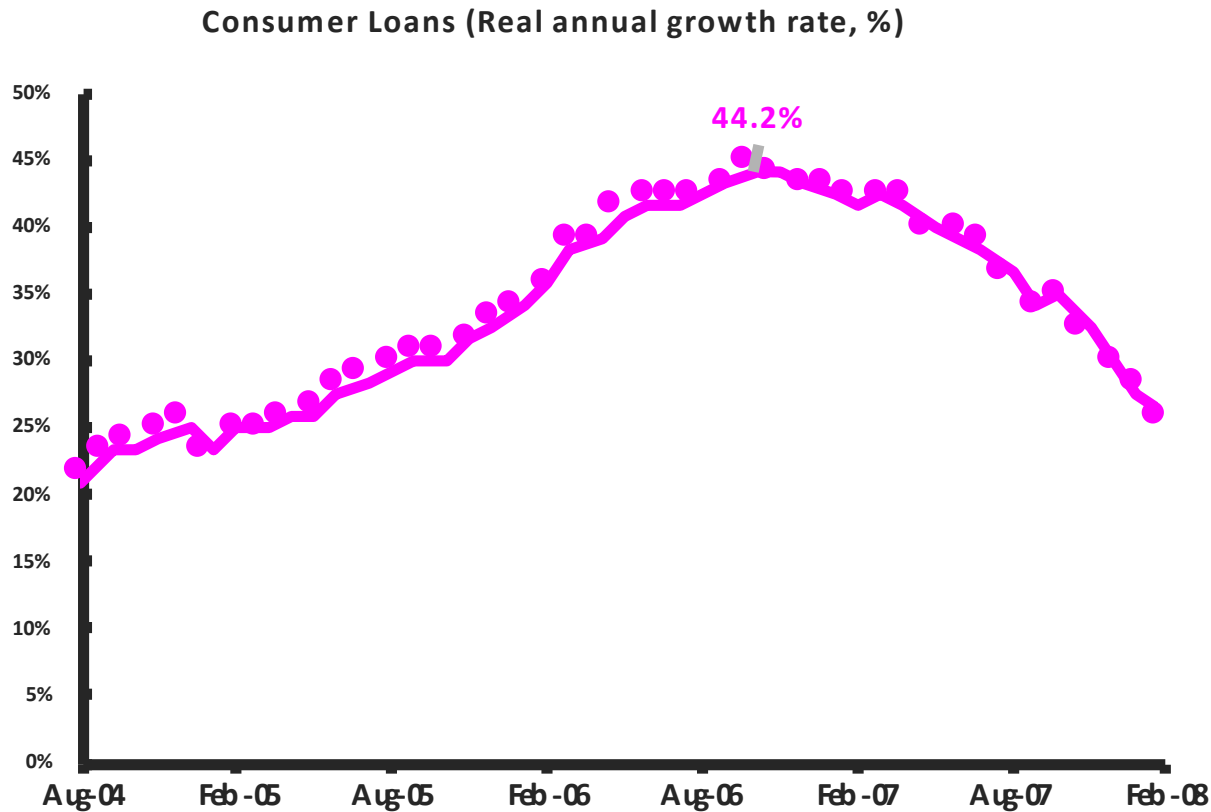
Source: IMF (2018)

# Readability of Central Bank Press Releases

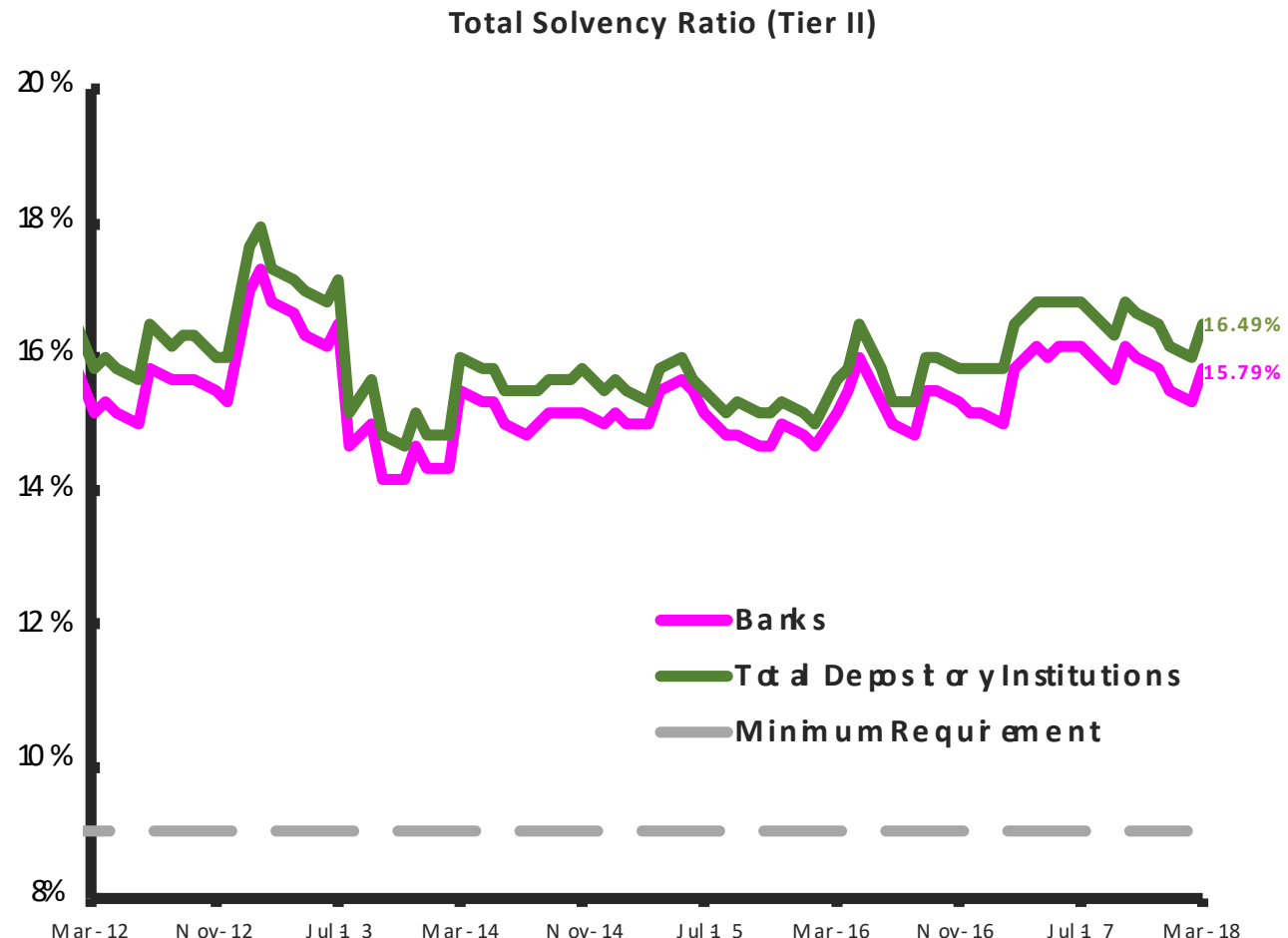
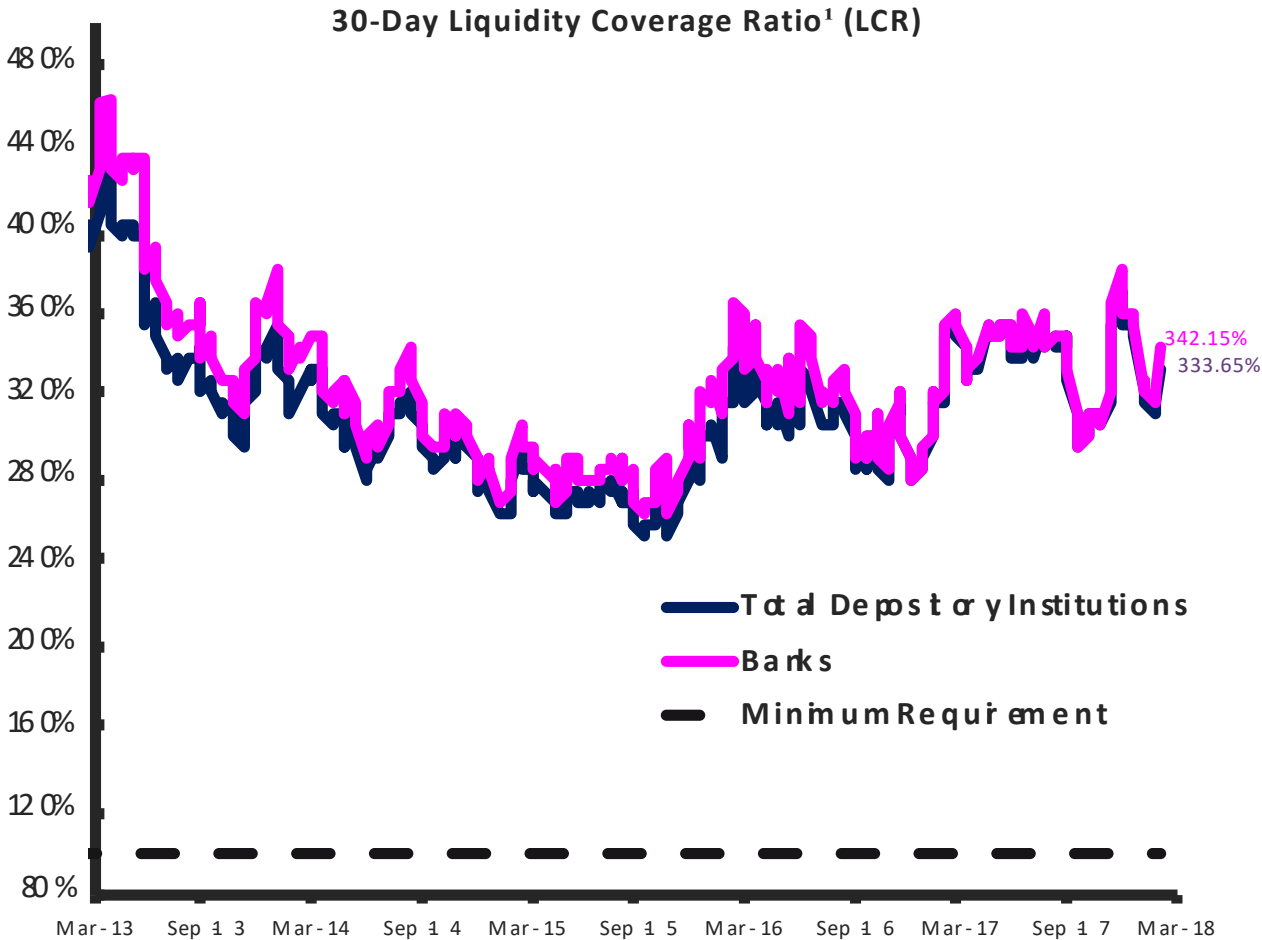


## 2. Complementing the IT Scheme With Other Policy Instruments and Objectives.

- Financial stability should be a shared concern of financial authorities; hence the IT scheme should be complemented with additional policy instruments.
- For example, in 2006-2007 we used temporarily domestic reserve requirements and unremunerated reserve requirements on capital inflows to curb excessive credit growth at a time when MP was tightening but the consumer loan interest rate kept falling.



- Preserving a solid and liquid financial system:
  - Avoids protracted slowdowns with possible effects on potential growth.
  - Allows the transmission of monetary policy.
  - Avoids “financial dominance of monetary policy”



<sup>1</sup> 30-Day LCR is the ratio of high quality liquid assets to total net cash outflows over the next 30 calendar days.



# Thanks

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