José Darío Uribe Escobar: Recent performance of the Colombian economy and the central bank's monetary policy reactions

Speech by Mr José Darío Uribe Escobar, Governor of the Central Bank of Colombia, at the Bear Stearns 2007 Colombia Conference, Cartagena, 28 September 2007.

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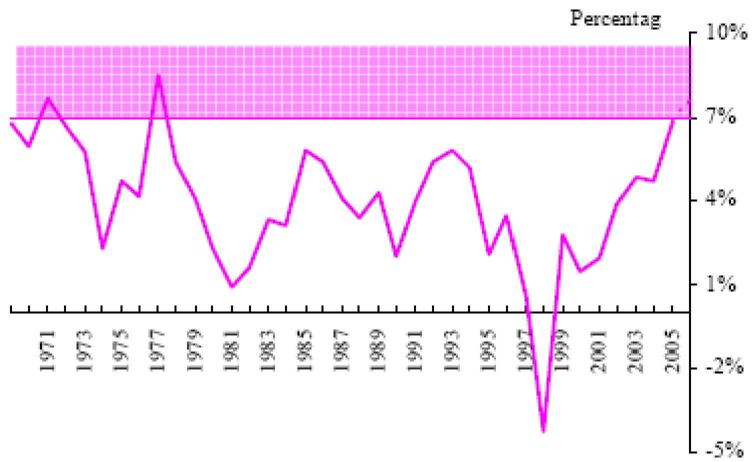
I. Introduction

Thank you for the invitation to take part in this event. I will begin by describing and interpreting the recent performance of the Colombian economy and then explain our monetary policy reactions. Then I will comment on the recent turbulence in international financial markets and how it might affect the Colombian economy. I will conclude with a summary of what I think are the key strengths of our economy and our policy framework and why they can cope with what may lie ahead.

II. The economic situation

The Colombian economy is growing at historically high rates. After expanding at around 5% for two years, it grew by 6.8% in 2006. This strong surge has continued into 2007. GDP growth in the first semester was estimated to be 7.6%, and available indicators suggest growth in the third quarter will surpass 5%. As illustrated in Chart 1, there have been very few years since the 1970s when the Colombian economy has expanded as fast as this.

Chart 1. GDP Growth (annual) since 1970

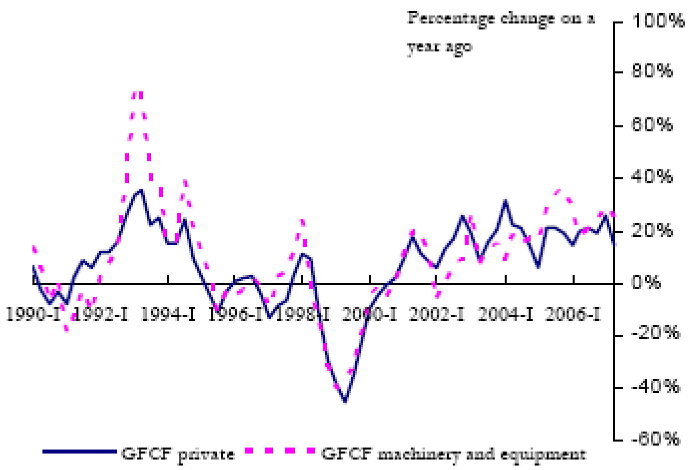


Source: DANE
Note: The data for 2007 is the GDP growth for the first semester of the year

Productive capacity and productivity also have increased at a high rate especially in industry and commerce. There is also an ample supply of labor.

Turning to domestic demand, the most noticeable feature in recent years has been the strong momentum in private investment. As Chart 2 shows, private investment has grown at two-digit rates since 2002 and, until recently, was concentrated in machinery and equipment. Private investment was up by 18.5% in 2006 compared to 2005 and up by 20% in the first half of 2007 compared to the first half of 2006. This momentum was stimulated by good prospects for economic growth, improvements in security and confidence, tax incentives and the combination of historically low borrowing costs and the real appreciation of the peso.

Chart 2. Private Investment and Investment in Machinery and Equipment



Source: DANE

The growth rate of real private consumption has been above 7% for three quarters. Consumption growth was supported by favorable financial conditions as well as a sustained increase in salaried employment. Our surveys tell us that families are optimistic both about their own financial prospects and those of the Colombian economy. Moreover a sharp increase in the terms of trade has contributed to income growth, and quite possibly made firms also feel optimistic about future profits. All this has boosted demand for goods and services.

Merchandise exports in current price dollar terms have doubled during the last four years. This applies to both traditional and non-traditional exports. In real peso terms, total exports were up by 7.8% in 2006 as a whole and up by 6.5% in the first half of 2007 compared to the first half of 2006. Our three fastest growing exports in terms of first semester annual growth rates were coal, transport equipment, machinery and electricity. When split by destination, we see that it is exports to Venezuela that have increased the most. This strong growth in exports reflects particularly favorable external conditions in Venezuela and more generally the improvement in international prices for Colombia's leading export products, and successful efforts of the Colombian private sector to increase productivity.

This is likely to continue in the near term. So far, there are very few signs of a reduction in the rate at which demand and output are growing. Domestic demand is still growing fast. The growth in Venezuela and high prices for our major export products continue to stimulate sales in the many companies that are focused on exports. I would expect GDP growth to lie between 5.8% and 7.7% in 2007 and then to moderate to about 5% in 2008.

As for CPI inflation, it is now currently at 5.2%, but down from 6.3% in April. This rise in our inflation in the first months of 2007 was in part due to a variety of special factors. Poor crops as a result of the El Niño weather condition caused a sharp rise in the price of certain foods during the early months of the year, particularly in perishable farm products. Then there was a boom in food exports to Venezuela that pushed up prices within Colombia for meat, eggs and chicken, among other items. Also important was the growing demand for food worldwide.

Part of high global food demand is due to the use of certain foodstuffs to produce bio-fuels, a phenomenon sparked by high oil prices and the incentives offered by some governments to produce alternative sources of energy.

As a whole food prices were responsible for nearly 70% of the rise in total CPI inflation over 2007! Table 1 breaks this down further into the different factors. Close to 73% of the rise in total CPI price inflation up to August of this year is attributed to the impact of food exports to Venezuela. For their part, the prices of foods affected by El Niño, which were the primary driving force pushing up inflation until a few months ago, are now a factor pushing down inflation. Over the period as a whole, international food prices have acted to push down on inflation but given recent rises in world market prices they could be a source of inflationary pressure going forward. But then there is still 28% which we attribute to domestic demand.

Table 1. Breakdown of Annual Inflation by Upward Pressure (at August 2007)

Description	Weight	Annual Growth		Share in points		Share in %	
		Dec-06	Aug-07	In the slowdown	In the build-up	In the slowdown	In the build-up
				since Jul-07	since Dec-06	since Jul-07	since Dec-06
Total	100.00	4.48	5.22	-0.55	0.74	100.00	100.00
Without food	70.49	3.95	4.31	-0.02	0.23	4.24	31.06
Tradables	21.67	1.71	1.37	-0.06	0.09	11.02	12.06
Non-tradables	36.77	4.75	5.56	0.03	0.25	-5.82	33.62
Regulated prices	9.04	6.12	6.61	0.01	0.07	-0.96	9.50
Food	29.51	5.68	7.23	-0.53	0.51	95.76	68.94
El Niño	7.15	2.79	1.68	-0.37	-0.09	66.77	-12.04
International prices	5.35	9.62	6.70	0.06	-0.15	10.10	-19.95
Domestic demand	9.52	5.83	8.12	-0.03	0.21	5.89	28.36
External demand (Venezuela)	7.48	5.81	13.08	-0.07	0.54	13.01	72.57

And the higher inflation was not just in food. Annual *non-food* inflation went from 3.6% in June 2006 to 4.3% by August of this year. The average of the three core inflation indicators used by the Banco de la República increased from 3.7% to 4.9% during the same period. The behavior of a series called "non-tradable goods excluding food and regulated prices" is particularly worth noting, with an annual price increase of 4.8% at December 2006 and 5.6% at present, including a major build-up in the months of July and August. All of this suggests that while the special food price factors were important, there was also an underlying demand-push pressure on consumer prices.

Inflation expectations for the short-term exceeded the target range. This too was important. If left to rise further, they could have fed the inflationary process and be reflected in wage negotiations, in company pricing policies, and in decision-making on financial markets. If not dealt with early on, high inflation would build up and force a more costly adjustment later on.

III. The orientation of monetary policy

Before I go on to interpret this data and to explain how we responded, let me remind you of the objective of monetary policy in Colombia. We aim to achieve low and stable inflation. For this year, the operational target is inflation between 3.5% and 4.5% but by the midterm we aim to keep inflation to within 1 percentage point of 3%. The objective of low, stable inflation is to provide the economy with a nominal anchor. But we recognize that monetary policy must also help to stabilize resource utilization in the economy near its average or long-term level as long as inflation expectations are anchored to the inflation target. The challenge, therefore, is to define an interest rate level for the central bank that is conducive to meeting the quantitative target for inflation and does its best to keep resource utilization close to its long-term level. The aim is to prevent the economy from either overheating or cooling too much.

As shown earlier, inflation in Colombia rose during first four months of 2007 and although it has fallen back it is still above the center of the target range. Only a portion of this increase is due to temporary agricultural supply conditions attributed to El Niño weather. Demand shocks that threatened persistent hikes in future inflation and imbalances that can jeopardize the sustainability of economic growth have been responsible for the rest.

Other evidence revealed an excess of demand above supply in Colombia, which, although moderate, is still visible. The various statistical techniques used to analyze the difference between actual and potential output (the GDP gap) all suggest the former exceeds the latter by somewhere between 1 to 2.5 percentage points. Most of the capacity indicators are close to historically high levels.

Another very straightforward piece of evidence is by how much our current GDP growth rates lie above historical averages. This year, the annual growth rate during the first semester was 7.6%, which is the highest for the first 6 months of a year since we have had quarterly data at our disposal. A situation where economic growth surpasses its historic average and the GDP gap that keeps positive represents a serious risk of inflation.

This demand pressure is also visible in our imports. Nominal imports in dollars have increased at an average annual rate of 34% since 2006. This is much higher than the 7.7% average growth observed since 1994. Nominal exports in dollars have soared as well, but less than imports. This means the current account deficit has risen every quarter since 2006.

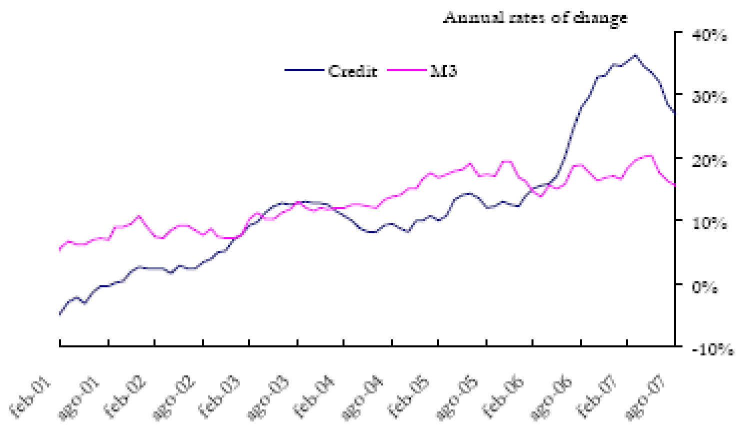
In summary, our challenge in the second half of 2006 and the first of 2007 was to deal with inflationary demand. Since April 2006, our monetary policy response has been to raise the Banco de la República's intervention interest rates by 325 basis points. As of May 2007, these hikes have been supplemented with a 24% average marginal reserve requirement on liabilities in the banking system.

What I want to emphasize is that in situations such as the job of keeping inflation close to a well – defined target is the same as keeping growth on a sustainable path. There was no trade-off. The growth rate of 11% in domestic demand during the first quarter of 2007 was too high. Had we let demand continue to grow at high rates, it would have meant not only excess inflation, but a worsening-quality and more risky investment, as well as an unsustainable current account deficit.

Let me also assure you that my colleagues and I at Banco de la República and in other areas of the government are very much aware that for growth to bring lasting benefits, it must be sustainable. We have public support for this goal. There is greater recognition on the part of the Colombian public that we must avoid repeating the damaging pattern of boom and recession.

The early evidence is that our preemptive and counter-cyclical actions have been working. Credit is becoming more expensive and is not expanding as quickly. The same can be said of the growth in monetary aggregates. Both series are plotted in Chart 3. People see a central bank that is making the right decisions and continuing in its effort to place inflation and inflation expectations on a path that is consistent with the targets that have been set. All of this will surely result in a more moderate increase in domestic demand, inflation that is on target, and an economy that is growing at a sustainable pace.

Chart 3. M3 and Credit



Source: Banco de la República
Note: Total credit in domestic currency

IV. Financial market turbulence and the Colombian economy

I would like now to discuss something that is I am sure on all your minds: the recent financial market turbulence triggered by problems in the US sub-prime lending market. We can never ignore the fact that the Colombian economy is affected by economic developments worldwide. This turbulence on international financial markets as of September has added to the uncertainty about the future of the economy worldwide and also for Colombia.

However, we should also recognize that this has happened after a sustained sequence of strong global growth. World growth is estimated to have stayed above 4% since the turn of the century and to have reached 5.4% in 2006. These rates are well above the average of 3.6% from 1970 to 2005[1]. This strong growth has meant that both private and public institutions worldwide have accumulated substantial reserves to draw on.

I am sure that the causes of the turbulence are well known to all of you. What is of prime interest is their eventual impact on the Colombian economy.

Financial turbulence is passed through to countries like Colombia through different channels. The following are the main ones: i) through changes in growth in the United States and in the world economy, and particularly in our most important trading partners; ii) through the drop in international prices for major export products and in the prices of imported goods (terms of trade); iii) through an increase in risk premia; iv) through changes in the direction of monetary

[1] IMF World Economic Outlook, 2007 I.

policy rates in the United States and in other advanced economies; and v) through changes in interest rates on government bonds in the industrial countries.

So far, all we can say about the impact of the international financial turbulence on the Colombian economy is that there was an important initial impact but most of that was quickly reversed: i) the Colombian peso depreciated 13.8% between July 15 and September 12 but then appreciated by 7.6% to September 26th; ii) the country-risk premium increased from 97 to 204 basis points from July 15th to September 13th but fell back to 147 basis points by September 26th; and iii) interest rates on TES 2020, the country's most liquid domestic government bonds, rose by 75.1 basis points from July 15th to September 13th but since then recovered 40 of those basis points.

In truth, we have as yet no idea how long the effects of the international financial turbulence on the real economy will last, or how strong they will be. But what we do know is that, over the years, Colombia has constructed a policy and institutional framework that makes the economy more resistant to negative external shocks. This policy framework includes an independent central bank that has lowered inflation, allowed exchange flexibility, and accumulated large amounts of international reserves. It also includes a government that has made it a policy, in recent years, to reduce the public debt as a share of GDP and has changed the currency composition of its debt to the point where nearly 65% is denominated in pesos (internal debt) and 35% in foreign currency (external debt).

And then our financial system is in good shape. It is deeper: the growth rates for assets, deposits, and loans in our banking sector recently reached historic highs. And at the same time it is more solid: during this rapid expansion, solvency ratios have remained well above the minimum capital asset ratio (9%). Loan portfolio quality (measured by the percentage of risky loans) has improved steadily too, on average.

Of course, there are important risks to be addressed by financial institutions and authorities alike. As we argued in our recent Financial Stability Report, the rapid growth in consumer lending is one concern. The undiversified nature of the portfolio of our non-bank financial institutions is another. We also argued that now is a good time to continue to make improvements in our regulations. Although these improvements would strengthen us further, there is no doubt that we are in better shape with respect to financial stability than when we faced international financial market volatility in the past.

Also from the point of view of our balance sheets, it is positive that our current account deficit has been mostly funded by foreign direct investment. The level of private sector indebtedness does not seem excessive. In historical terms, there is less currency and maturity mismatches in balance sheets.

Finally, headway is being made in integrating us further with world trade through various means, one of the most important being bilateral trade agreements.

A strong framework of macroeconomic and financial policies means that the Colombian economy can better absorb changes in the international economy, be they temporary turbulence or more lasting adjustments. Let me remind you that our inflation targeting scheme allows us to be flexible and discretionary in how we respond to shocks such as these.

But in exchange for this flexibility in our instruments, we must keep fixed on three commitments. The first is our monetary policy objective: we must try and keep inflation close to its target path without letting the output gap fluctuate excessively. The second is to explain our actions, so the private sector can plan accordingly. The third commitment is on the part of our partners in the government to support this effort with an appropriate fiscal policy and financial supervision. This strategy should help with whatever awaits us on the road ahead.

Of course, we will continue to monitor developments carefully. But we should not let events on international financial markets distract us unnecessarily from these three commitments. If we perceive a further threat to inflation, we should act preemptively to avoid reaching a point where we would have to deal with high domestic inflation, a larger current account deficit and higher international market spreads.

V. Concluding remarks

In conclusion, the Colombian economy has grown very strongly in 2007 as it did in 2006 and 2005. The growth was not just in consumption. Private investment, especially in machinery and equipment, and exports have increased strongly too. We can now surely say that our productive capacity has recovered from the recession of the late 1990s.

But we are also aware that we must not let domestic demand rise too far above productive capacity. This would create inflation pressure. In my review of the data, I concluded that although much of inflation was due to temporary fluctuations in food prices, there was also some underlying demand pressure. Evidence from a wide variety of other data corroborated that domestic demand was growing too fast. Excess demand would mean not just inflation but that imports were stimulated to feed a large current account deficit. Thus the rises in our interest rates since April 2006 have been aimed both at containing inflation pressure and keeping our economy on a sustainable path.

I discussed some of the likely channels through which the recent turbulence in international financial markets could come to affect us in Colombia: through international demand for our exports, through changes in terms of trade, and through market interest rates. I also reminded you of the key strengths in our policy framework. We have an independent central bank that keeps firm on its objectives; a government that acts to keep public debt to within sustainable limits, and we have a financial supervisory authority that improves and strengthens our regulatory framework. If we keep to this, we should be well protected against whatever lies ahead.