Keep in mind



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I must begin by saying something that you know very well. The policy interest rate of Banco de la República (the Central Bank of Colombia) has drastically increased over the past year and a half, completing an increase of 11 pp since the beginning of the current cycle of increases in September 2021. We are talking about the strongest monetary policy adjustment process that has taken place during this century and since the Bank adopted the inflation targeting strategy that now guides our decisions.

The effects of this increase have already begun to be experienced in recent months on aggregate demand, imports, and loans, among other variables. These effects are generally painful and clearly unpopular. Unfortunately, inflation has continued to rise; however, in Colombia, we have not yet seen a break in the trendline as has already occurred in many other countries in the region and the world. The multiplicity of inflationary shocks that Colombia has received, including the strong accumulated depreciation of the Colombian Peso in the last two years, has combined with the complex indexing mechanisms we have in Colombia to generate considerable lags in the impact of the monetary policy adjustment process on price dynamics. Nevertheless, we expect that the process of returning inflation to the target will begin to be observed in the coming months and may be completed by the end of 2024, as we announced after the Board of Directors' meeting last November.

I would like to take the opportunity of this scenario to describe the diagnosis of the main macroeconomic variables and comment on their prospects for the year ahead. Thus, I will first refer to the productive activity and the indicators of demand performance. Then, I will turn to inflation performance and outlooks.

## Aggregate Demand, Employment, and Productive Activity

The first thing worth noting is that productive activity and employment were much more dynamic and robust in 2022 than anyone had imagined. The real GDP growth would have been 8.0%, a rate that by far doubles the growth of Latin America and which the IMF estimates at an average of 3.9%. Last year, very few countries in the world showed growth rates higher than Colombia's. The only ones I can identify with the highest growth are Saudi Arabia and Guyana, in both cases, due to significant increases in oil production.

The high growth of the Colombian economy in 2022 was undoubtedly a positive thing, and it would be desirable to grow again at similar rates in 2023 and subsequent years. The problem here is that it was an unsustainable growth driven by an excess in demand that generated complex imbalances on different fronts

1. On the one hand, these imbalances are reflected in the inflationary pressures, to which I will refer in a moment.
2. They are also reflected in the current account's deficit of the balance of payments, which reached levels estimated at 6.3% of GDP, reflecting increases of about 30.0% in the dollar value of imports that could not be covered by the increase in exports, despite good performance of international oil and coal prices. This high deficit requires significant financing needs and makes the economy more vulnerable.
3. Likewise, the excess demand was manifested in consumer credit growth that for most of the year exceeded 20.0%, a rate much higher than the income growth, which will be reflected in a growing financial burden for households.

As I said at the beginning, the tightening of monetary policy and the consequent increase in interest rates have already begun to be reflected in a less dynamic demand and an adjustment of the imbalances I have just mentioned.

1. Thus, the dollar value of imports went from growing at rates close to or above 40.0% until August to a negative growth rate in November. Therefore, our perspective is that the external deficit in

the current account of the balance of payments will fall from 6.3% of GDP in 2022 to 3.9% of GDP in 2023. Contributing to this adjustment will be the monetary adjustment and the significant reduction in the budget deficit expected in 2023, according to the government's financial plan (which falls from 5.5% of GDP in 2022 to 3.8% of GDP in 2023).

2. Moreover, economic activity as measured by the monthly economic tracking indicator (ISE in Spanish) is slowing down its growth rate. In November, it showed an annual growth of 3.0%, considerably lower than in previous months.
3. Meanwhile, consumer credit, which reached growth rates close to 23.0% per year in the third quarter of 2022, has reduced its growth rate to levels below 17.0% in recent weeks. The slowdown has been much lower in housing loans, whereas in commercial and microcredit cases, the latest data show higher growth rates than in previous months.
4. These trends are part of the adjustment process of demand to sustainable levels.

It is well-known that the projections of *Banco de la República's* technical staff for economic growth in 2023 are among the lowest of all analysts. It is estimated that this growth would only be 0.2%. However, it is important to note that, even with such low growth, the levels of activity that we would have in 2023 would be relatively high. Actually, the adjustment in the growth rate between 2022 and 2023 is largely due to a base effect. Therefore, if we compare the cumulative growth of Colombian GDP to pre-pandemic levels, our performance would remain broadly favorable with respect to other countries in the region.

On the other hand, it is worth noting that the labor market is performing relatively well in the context of the recent slowdown in growth. Indicators to December for the country's urban areas show an annual growth rate of the employed population of 7.5% in the 13 main cities. However, this increase has been partially offset by a less positive employment performance in rural areas and the seats of the smallest municipalities. This phenomenon is probably associated with poor performance in agricultural and livestock production. On the other hand, the number of salaried employees at the national level shows an above-average growth, reflecting a dynamism of formal employment that is confirmed in the data on the number of contributors to the Integrated Social Security Contribution Form (PILA in Spanish).

## Inflation and Expectations

- Moving on to the inflation performance, the figures released last weekend for January show that, unfortunately, the adjustment process in demand has not yet begun to be reflected in inflation performance, which continues to rise.
- **Total inflation** now stands at **13.25%** and keeps being driven by food prices, rising to **26.2%**, which is particularly high when we consider that **food prices** were already rising at 19.9% in January 2022. This means that in the last two years, food price levels have increased by more than 50.0%, which implies an increase in the relative price of this item of the family basket considerably greater than what can be explained by global factors. In part, this increase could be associated with purely sectoral supply factors, which would also explain the poor performance of the agricultural and livestock sector in a year in which all other sectors grew strongly.
- On the other hand, **core inflation**, which corresponds to the basket that excludes food and regulated products, showed a rate of 9.78% in January, growing 25 bps compared to the one observed in December.
- The fact that inflation indicators, and particularly core inflation, continue to increase in Colombia

contrasts with the situation of many other countries, including not only the most developed ones but also several in Latin America, such as Brazil, Mexico, Peru, and Chile, where there are clear indications that the upward cycle of inflation has already peaked.

- The factors that explain the persistence of the upward trend in the Colombian case would be summarized, in my opinion, in three elements:

1. First, despite the slowdown in demand growth, **excess demand persists**, which can be expressed more technically in the idea that GDP remains above the potential or that the output gap is still positive. This situation emerges from the fact that growth was atypically high in 2022, more than double the Latin American average, strongly driven by demand. Estimates by the Bank's technical staff suggest that positive GDP gap accumulated in 2022 would persist during the first three quarters of this year.
2. A second element to explain the persistence of inflationary pressures in Colombia relates to price **indexation**. The high inflation rates seen in 2022 have triggered indexation mechanisms, including a 16.0% increase in the minimum wage and sharp adjustments in the prices of some utilities, particularly electricity. These indexing mechanisms reduce the credibility of the target and probably force a tighter monetary policy than would otherwise be required for a successful anti-inflationary policy.
3. **The depreciation of the Colombian Peso** is the third factor that helps explain the greater persistence of inflationary pressures in the Colombian case compared to other countries. With numbers as of yesterday (8 February), the depreciation of the Colombian Peso in the last twelve months exceeded 20.0%, and in the last two years, it was close to 35.0%. The last depreciation number for the Colombian Peso (35.0%) contrasts with a nominal appreciation for the same period of Brazil, Mexico, Costa Rica, and Uruguay currencies. In the case of Chile, a depreciation is seen but much lower than the Colombian one, at 9.2%. Similarly, the exchange rate of the Peruvian Sol depreciated compared to its level two years ago, but only 5.7%.

The contrast between the strong depreciation of the Colombian Peso in the last two years and what happened in the main countries of the region with which we usually compare ourselves can be explained in part by the relative deterioration in our country's fiscal soundness, which led to the loss of its investment grade in 2021. Recently, a better perspective of fiscal adjustment has been seen with the 2022 tax reform and the announcements of the Financial Plan regarding compliance with the adjustment plan contemplated in the fiscal rule, which contributed to the Colombian Peso appreciation of last December and January in a favorable international environment. However, it must be recognized that uncertainty about the future of oil and coal exploration and exploitation has kept the exchange rate highly vulnerable to international events. It also helps to explain that in international situations of greater risk aversion, such as the one observed this week, the Colombian Peso suffers more significant depreciations than other currencies in the region.

## Inflation Outlook

What is the outlook for inflation for 2023 and 2024? The first thing I must say is that Banco de la República is strongly committed to creating the necessary conditions for returning inflation to the target. The Bank's technical team's projections suggest that, although by the end of this year, we would still have the permissible range of 3.0% +/- 1.0%, we would reach that range by the end of 2024.

As we stated in the press release issued after the last meeting of the Bank's Board of Directors, with the decision to increase the policy interest rate by 75 bps last January, the monetary policy approached the position required to induce in the medium term a convergence of inflation towards its 3.0% target.

Indeed, the uncertainty is considerable, and future decisions will depend on the information we have at any given time. However, in our central scenario, we expect inflation to be approaching a decreasing path, which would initially be driven by a substantial reduction in the growth rate of food prices. Core inflation would continue showing increases for the rest of this semester. Still, the outlook is that in the second half of the year, it will also start to show a decreasing trend, reinforcing the behavior of food prices and helping the convergence process toward the target. This process would continue throughout 2024.

Surely there is great uncertainty, and there are risks in projections such as those described. In addition, those projections imply the continuation of a contractionary monetary policy, even if it means lower growth than would be otherwise desirable.

In public discussions on the contractionary monetary policy adopted by Banco de la República, there is often a dilemma between the search for lower inflation and the cost this causes in terms of economic growth. I honestly think this is a false dilemma. The alternative we have is not between lowering inflation or growing more. On the contrary, reducing inflation is essential to bring long-term interest rates back to low levels, which will stimulate investment; and to increase growth in the medium and long term, even if it means sacrificing some short-term growth.

Ensuring credibility in the inflation target is also essential for monetary policy to have a countercyclical and stabilizing nature in the future, as it, fortunately, did during the COVID crisis. The monetary impulse during the pandemic was undoubtedly crucial to the prompt recovery we have fortunately noticed over the past two years.

**Leonardo Villar**
Cartagena, February 9th 2023