Banco de la República’s (the Central Bank of Colombia) policy strategy aims to maintain a low and stable inflation rate as well as to achieve output levels close to their potential value. Likewise, the Bank's policy contributes to preserve financial stability and the payment system. Exchange rate flexibility is considered a fundamental element in achieving these objectives. Firstly, in a flexible exchange rate regime, it operates as an adjustment variable in response to shocks to the economy, reducing the volatility of economic activity . Secondly, exchange rate flexibility allows for the interest rate to be used independently as an instrument to bring inflation and output closer to their desired values. Thirdly, exchange rate flexibility reduces incentives to take excessive currency risks, which is vital to maintain financial stability.

Despite the above, *Banco de la República*, as the foreign exchange authority , has the power to intervene in the foreign exchange market. Such intervention does not limit exchange rate flexibility nor does it aim to fix or reach any specific exchange rate level. Rather, it pursues objectives compatible with the inflation targeting strategy. Specifically, the Bank's intervention seeks to: i) increase the level of foreign reserves to reduce external vulnerability and improve access to foreign credit ; ii) mitigate exchange rate movements that do not clearly reflect the behavior of the economy's fundamentals and that could negatively affect inflation and economic activity; and iii) moderate rapid and sustained deviations of the exchange rate from its trend in order to prevent disorderly behavior in financial markets.

To ensure the compatibility of foreign exchange intervention with the inflation targeting strategy, foreign exchange purchases and sales are sterilized to the extent necessary to stabilize the short-term interest rate at the level that the Board of Directors of *Banco de la República* (BDBR) considers consistent with the achievement of inflation target and with the evolution of output around its potential level. This means that the monetary expansion or contraction generated by foreign exchange purchases or sales is offset so that the short-term interest rate does not deviate from the level prescribed by the BDBR.

The intervention decision considers its benefits, its costs for the country, and its impact on the Central Bank's financial statements. Foreign currency purchases are determined in such a way that the external liquidity level of *Banco de la República* matches the external deficit, external debt payments, and other potential capital movements.