

Macroeconomic risks and policy challenges for **COLOMBIA** of rising international interest rates



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Background

Colombia: Recovering from the terms of trade shock

Following a severe shock, the Colombian terms of trade and trading partners' growth are expected to continue recovering. However, downside risks persist.

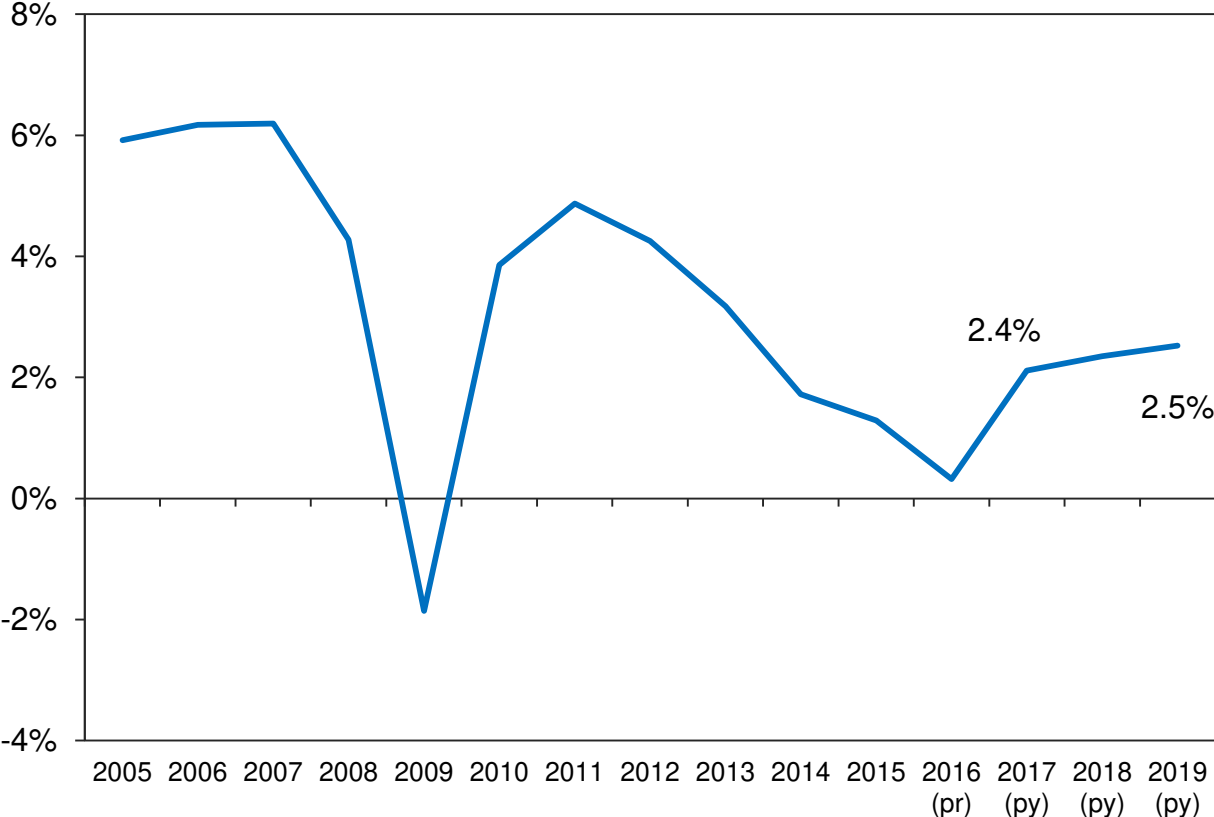
Terms of Trade

(Index)



Growth of Colombia's Trading Partners

(Percentage)

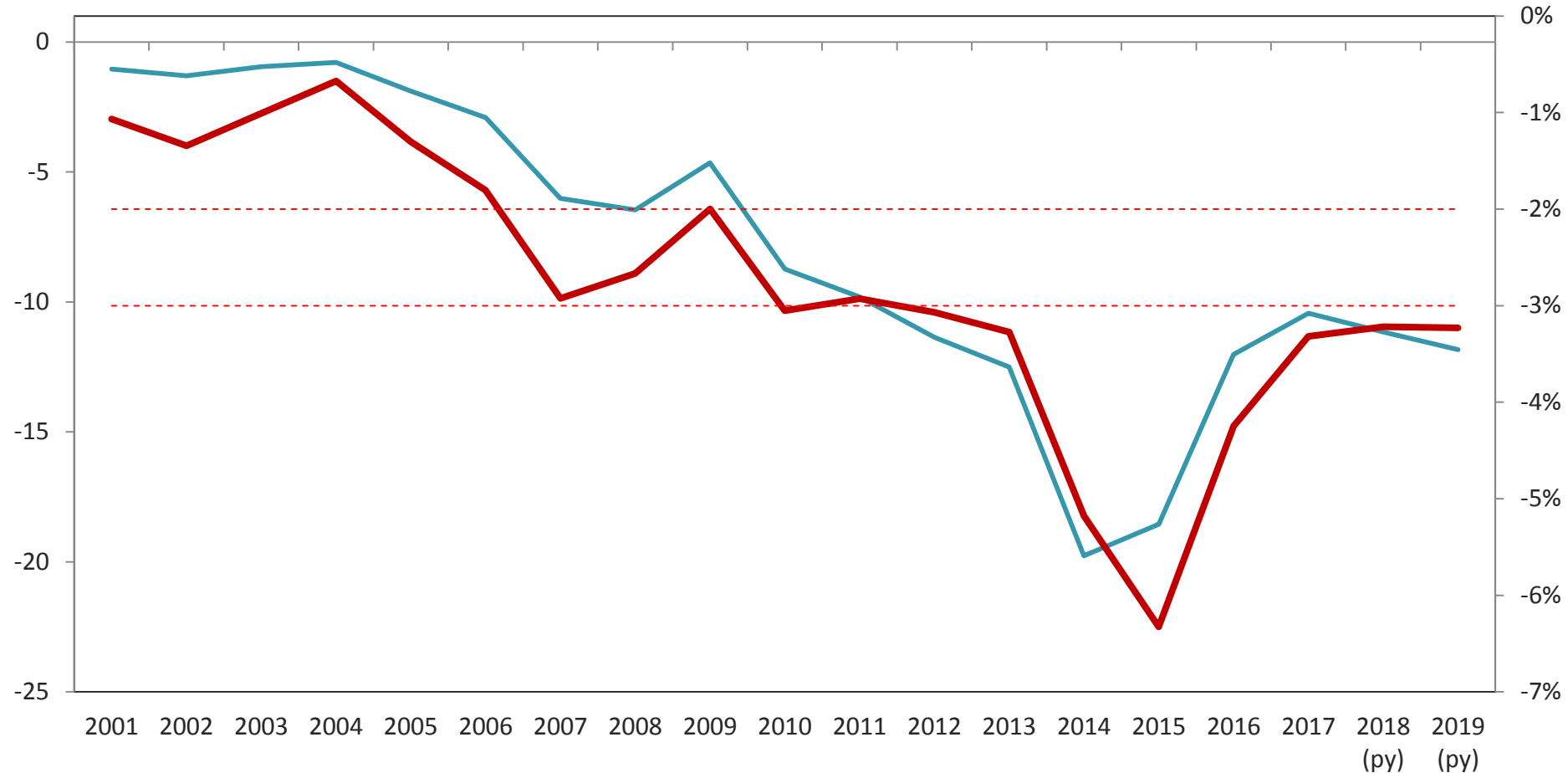


Source: Banco de la República.
Latest update (july-2018)

Source: Banco de la República.

By 2015, the current account deficit attained 6,4% of GDP. Over the last three years there has been a significant correction , and currently it is close to sustainable levels.

Current Account
(Percentage of GDP and Billions of U.S. dollars)



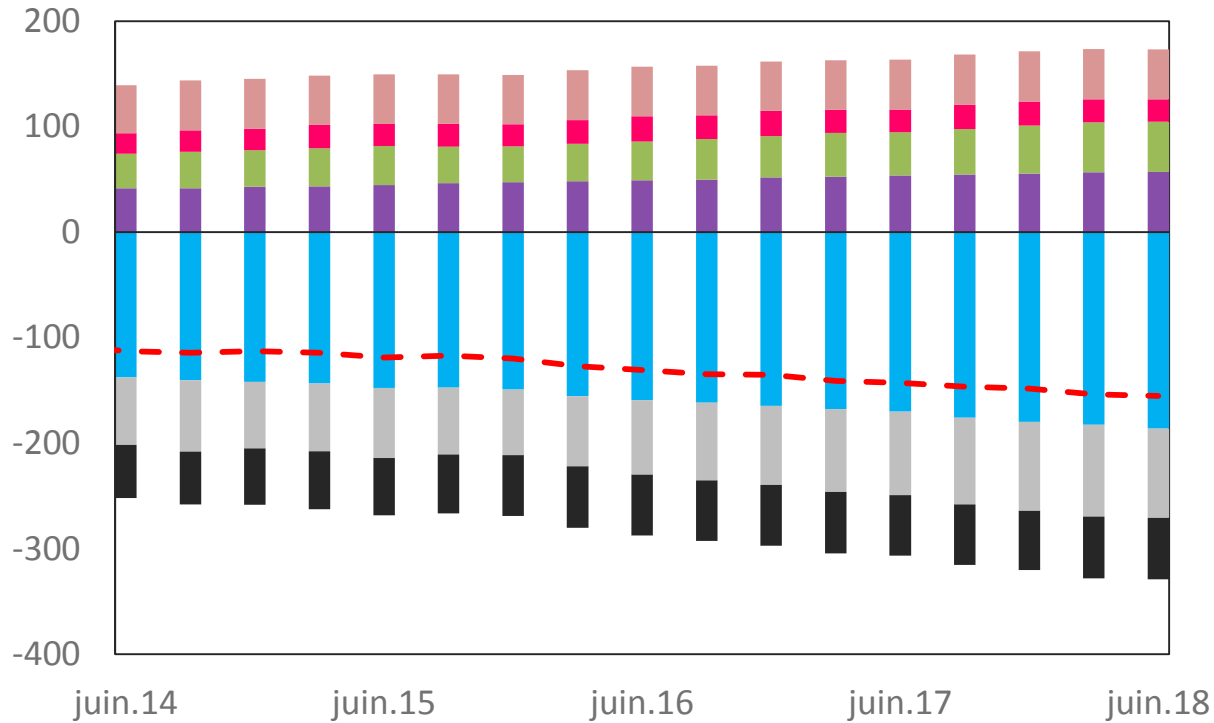
Source: Banco de la República

— Billions of U.S. dollars — Percentage of GDP (Right axis)

Continued access to external financing and exchange rate flexibility, helped to cushion the effects of negative external shocks.

International investment position

(Billions of U.S. dollars)

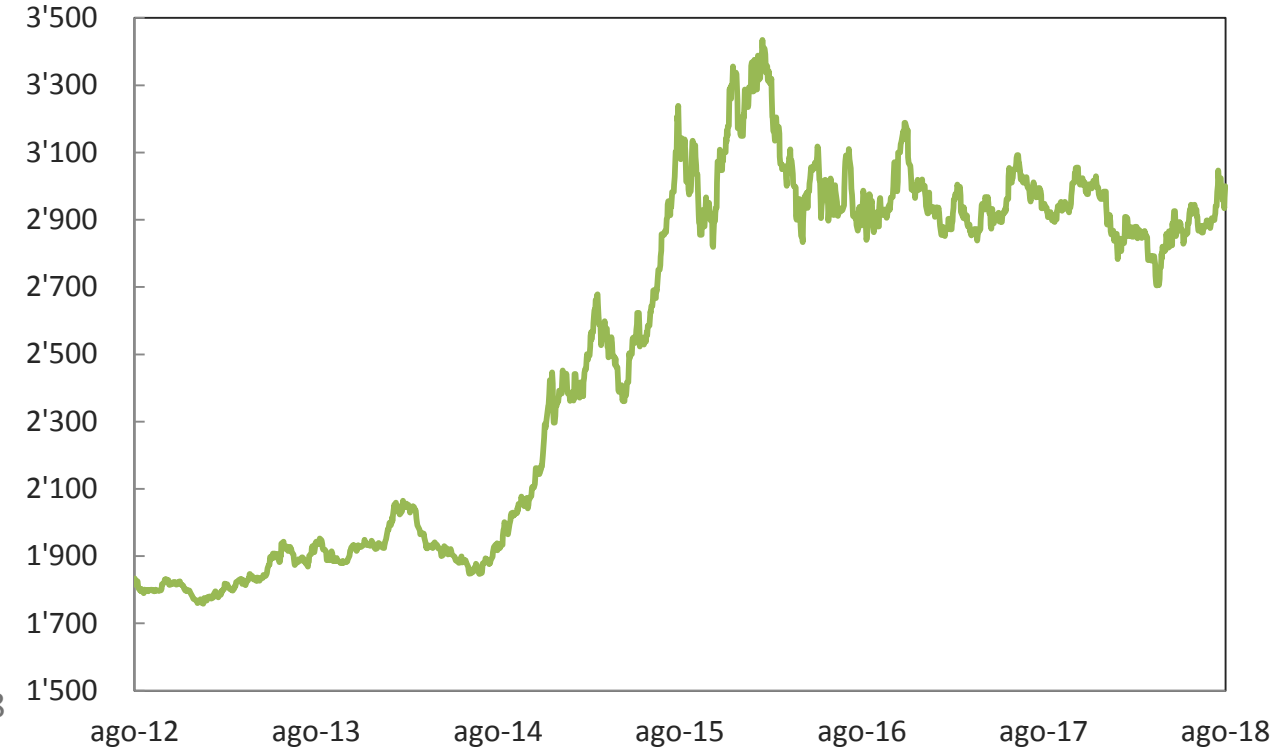


- Direct investment (Assets)
- Other investment (Assets)
- Direct investment (liabilities)
- Other investment (liabilities)
- Portfolio (Assets)
- Reserve assets
- Portfolio investment (liabilities)
- Net IIP

Source: Banco de la República

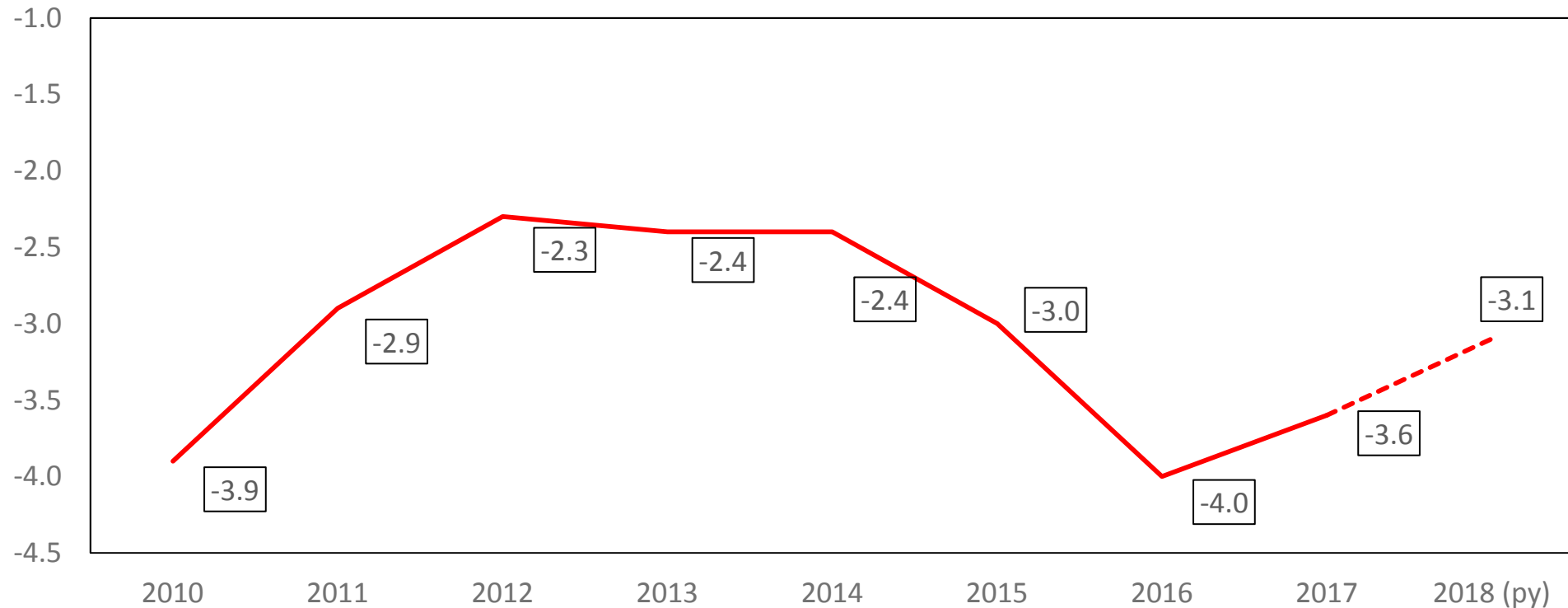
Nominal Exchange Rate

(COP/USD)



The shrinking of oil revenues deteriorated the government's balance. Two consecutive tax reforms (2014-16) and expenditure austerity allowed the Central Government to reduce its negative balance. The forthcoming tax reform will continue strengthening its fiscal position.

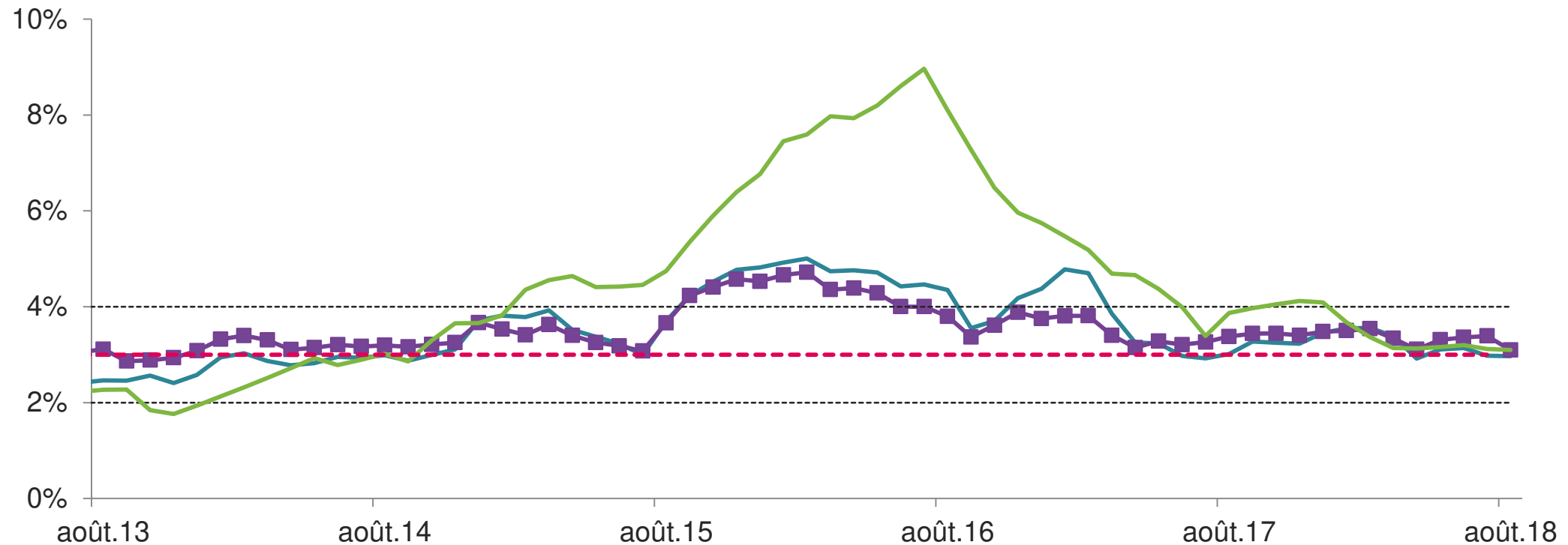
National Government balance
(Percentage of PIB)



Due to exchange rate pass-through and climate factors, consumer's inflation accelerated. However, most recently both inflation and its expectations have been converging to the 3.0% target.

Inflation Rate and Inflation Expectations Implicit in Government Bonds (TES of 2 and 5 years)

(Percentage)



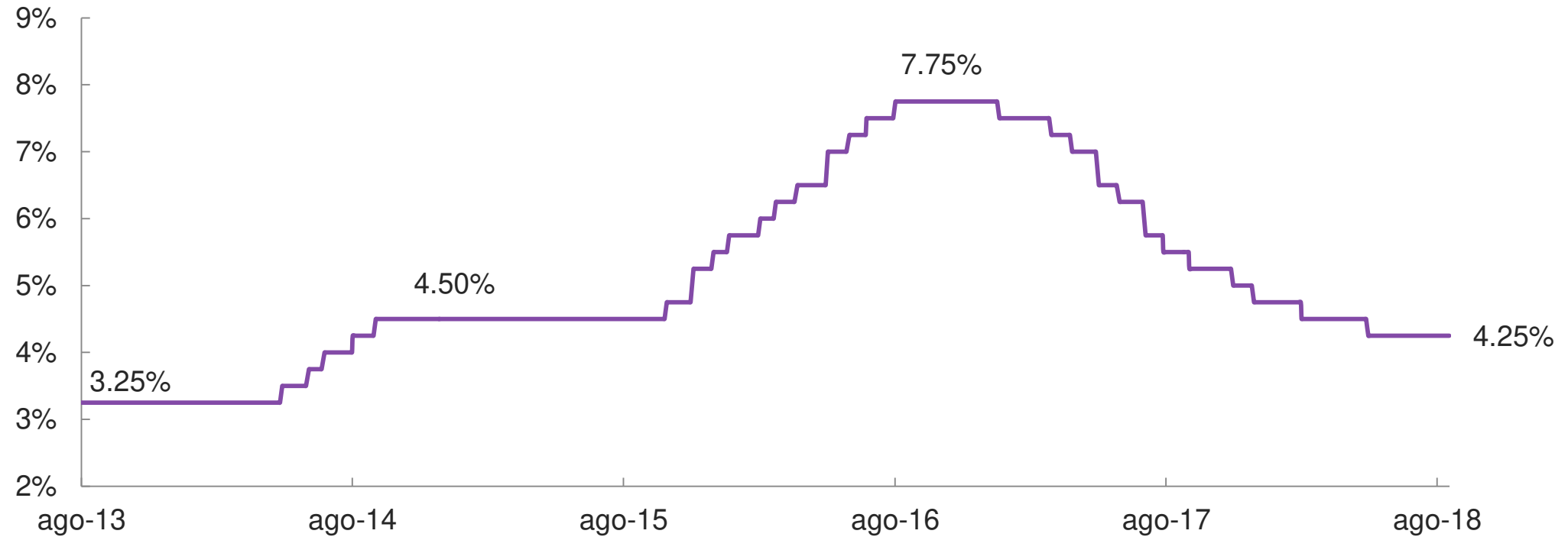
Source Fuente: DANE. ; Calculations by Banco de la República.

— 2 years —■ 5 years — Total Inflation - - - Inflation target

The credibility of the monetary regime allowed a gradual response. First, a delayed tightening, just enough to tame rising inflation expectations. Then a monetary stimulus, to encourage economic recovery.

Policy Interest Rate

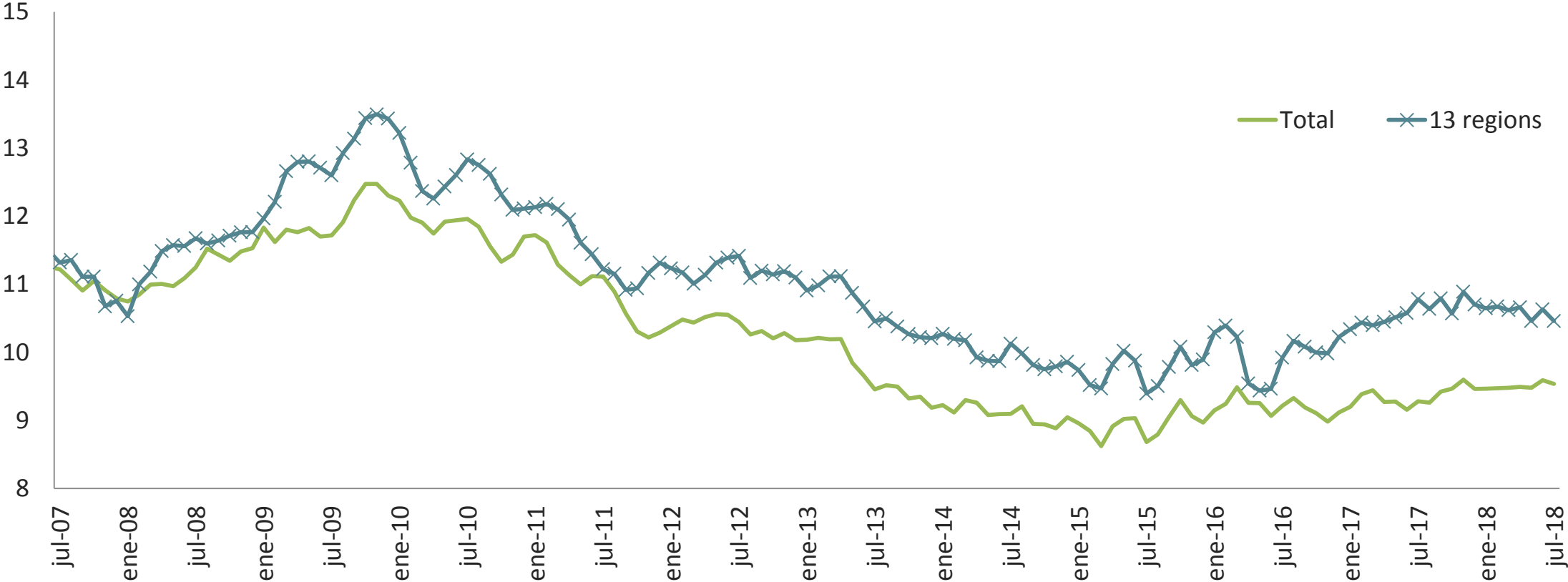
(Percentage)



The labor market has been resilient to the economic slowdown. Rural labor explains part of these developments.

Unemployment Rate

(seasonally adjusted quarterly moving average)

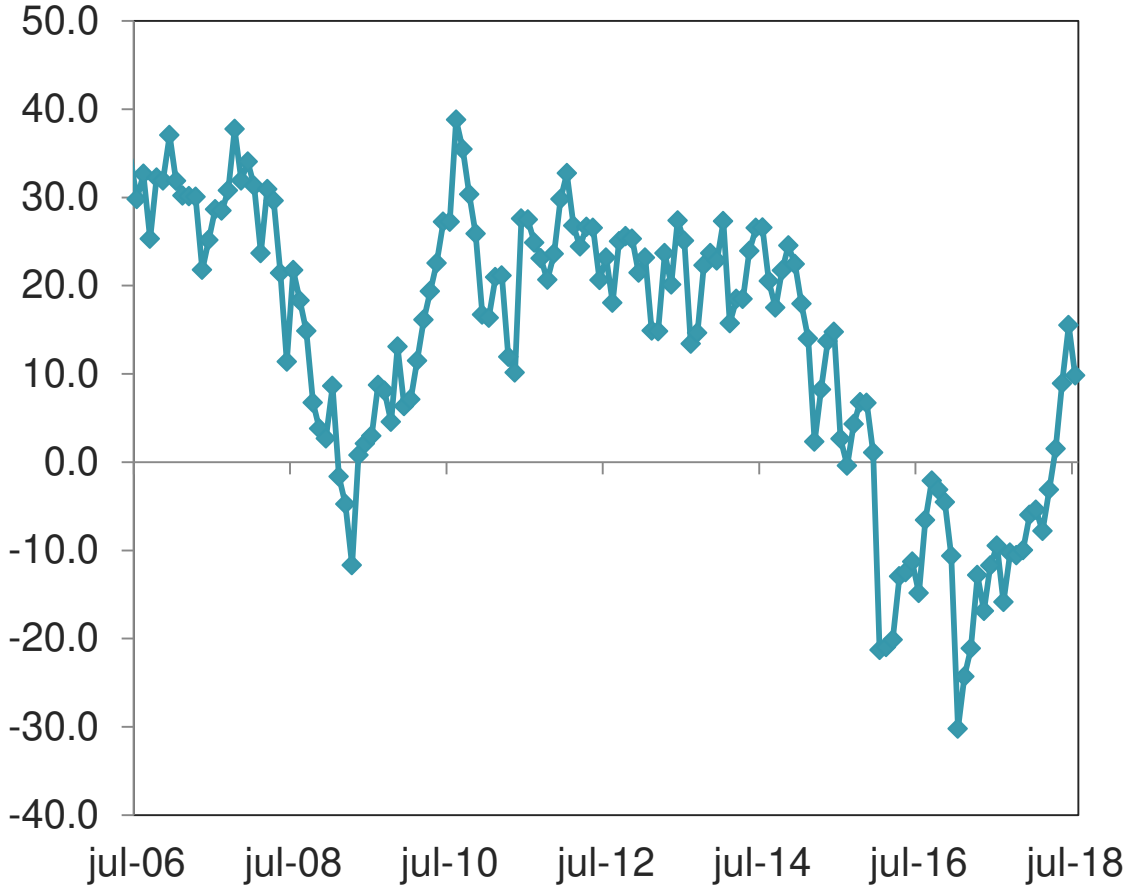


Source: GEIH – DANE.

Progress in the economic adjustment has contributed to the improvement of consumers and entrepreneurs' confidence.

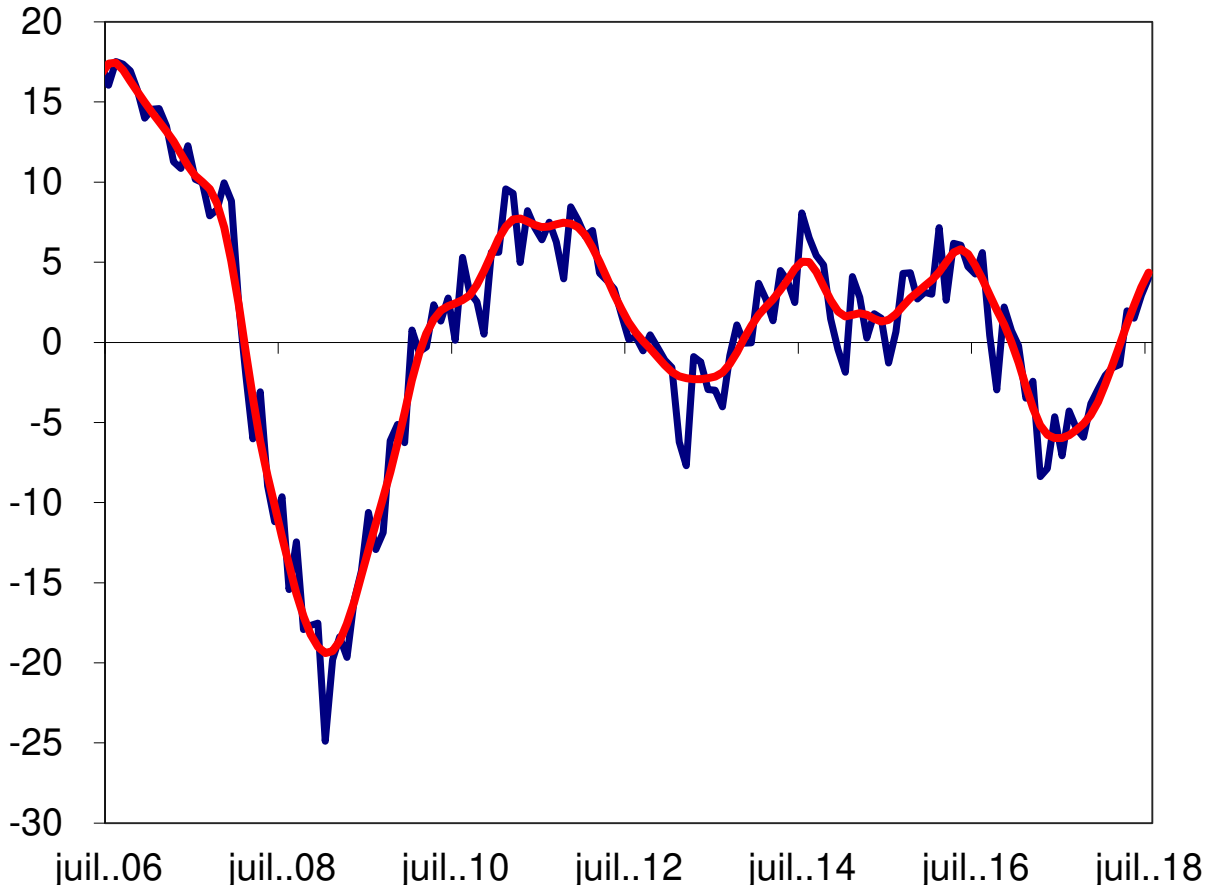
Consumer Confidence Index

(monthly indicator)



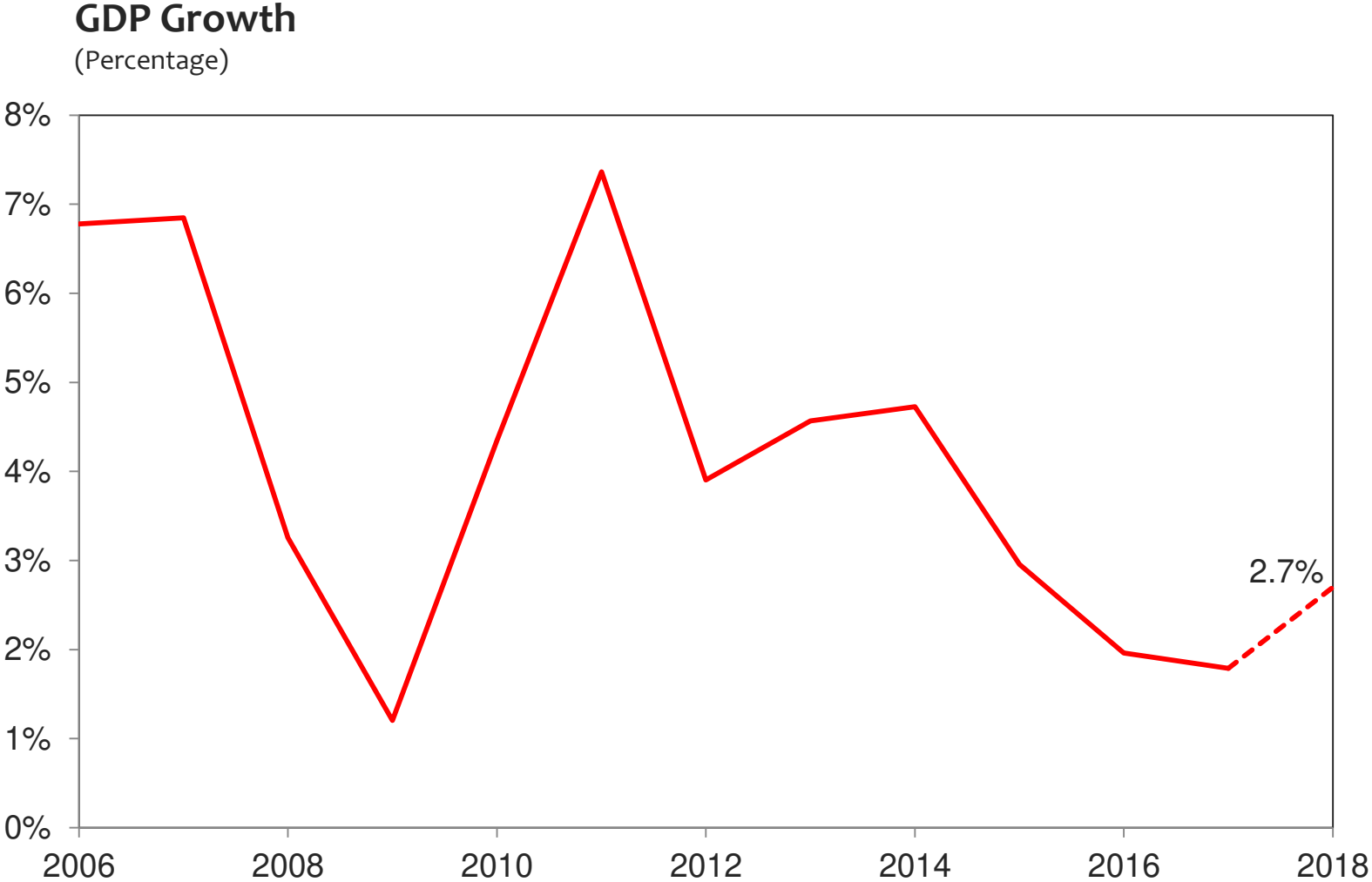
Manufacturing industries Confidence Index

(Seasonal adjustment)



Source: Fedesarrollo.

Economic activity is starting to pick up. Nonetheless, current GDP growth continues to be below potential, estimated at an annual rate of 3,5%



Source: DANE and del Banco de la República.

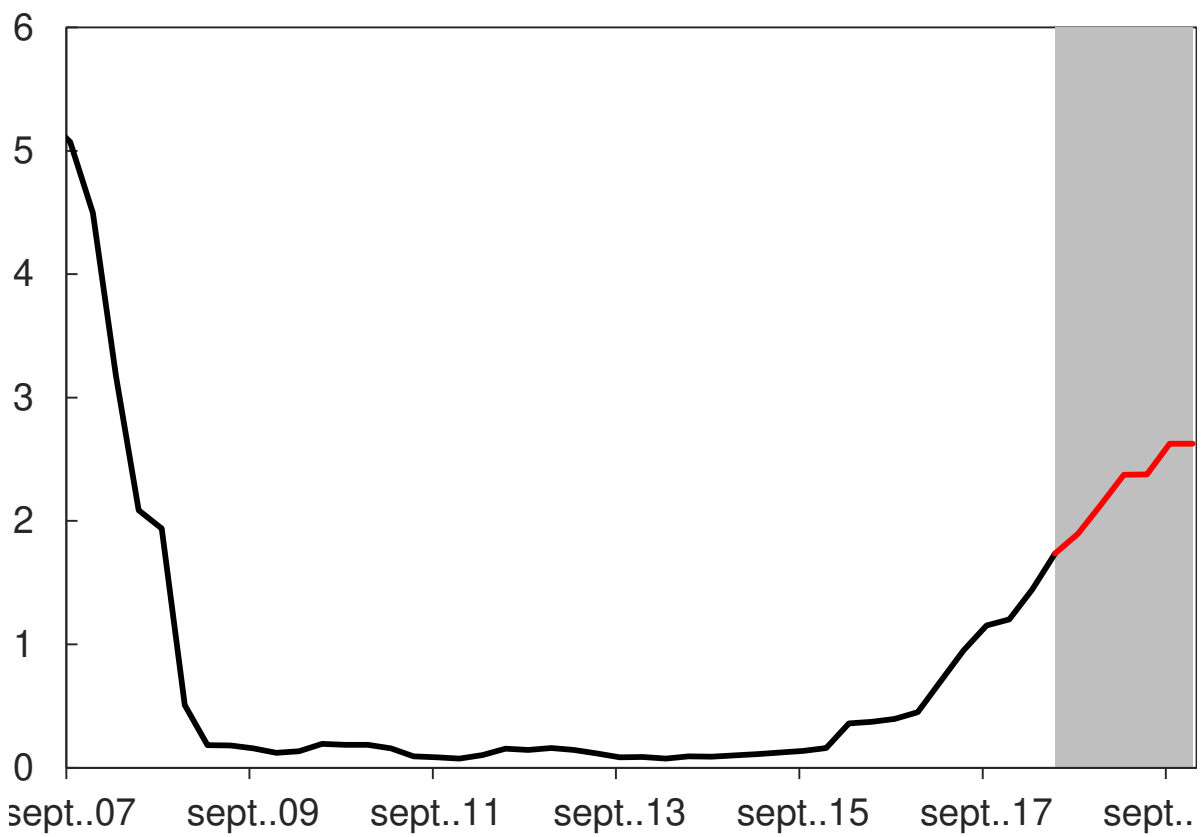
Macroeconomic risks and Policy challenges

Current macroeconomic risks arise from changes in external conditions

- **Financial**
 - Monetary policy normalization in the US
 - Increases in risk aversion
 - Dollar appreciation
- **Non-financial**
 - Fall in commodity prices
 - The resurgence of protectionism

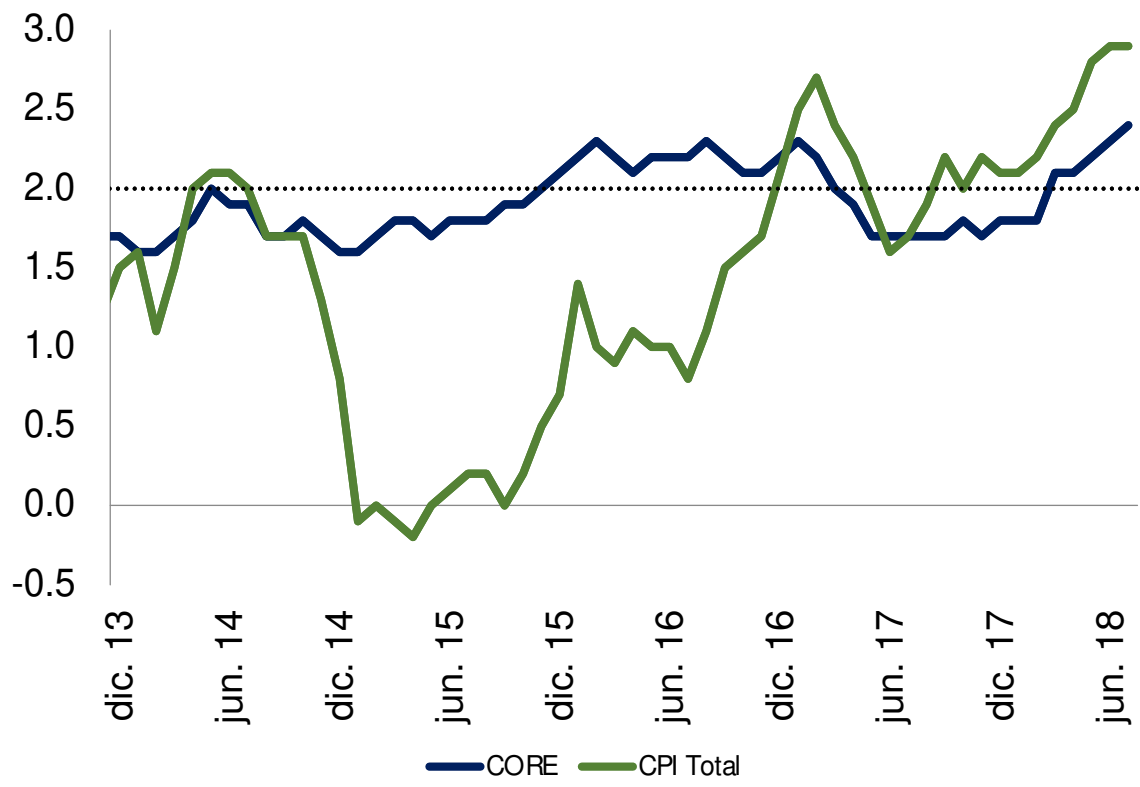
The Federal Reserve continues tightening its monetary policy, as core and total inflation are rising and unemployment registers historical low levels

Monetary policy rate (Fed)
Average of quarterly effective rate
(Percentage)



Source: Bloomberg and Banco de la República.

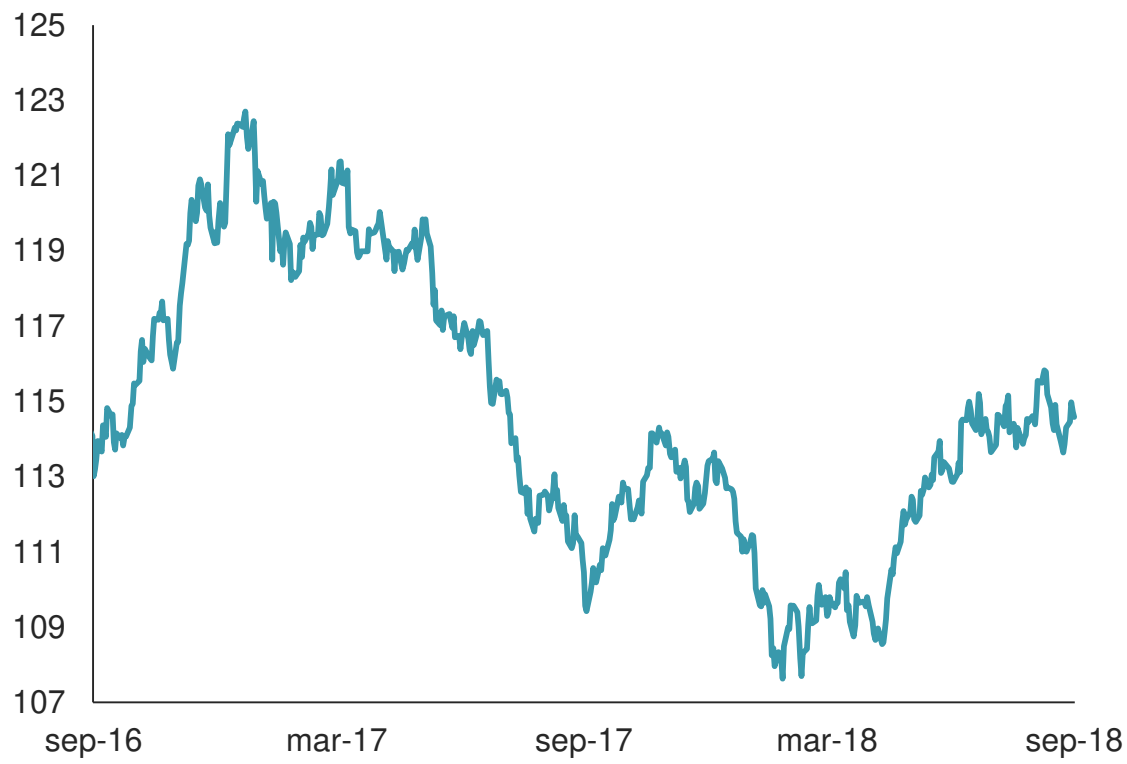
Annual inflation rate
(Percentage)



Source: Bloomberg

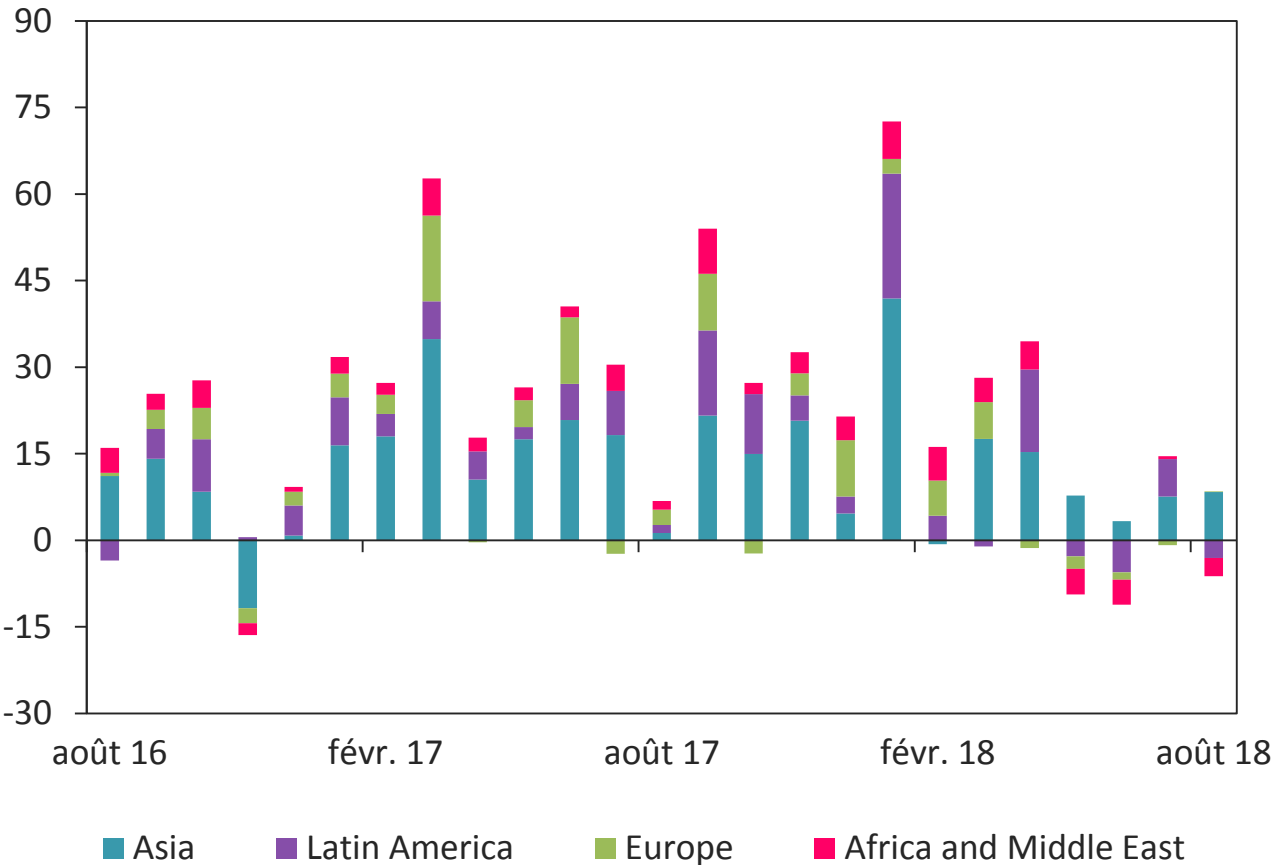
Higher interest rates and dollar appreciation could generate a reversal of capital flows and an increase on the cost of financing for emerging economies.

Dollar index
(2014=100. Weighted by international trade)



Source: Bloomberg and Banco de la República.

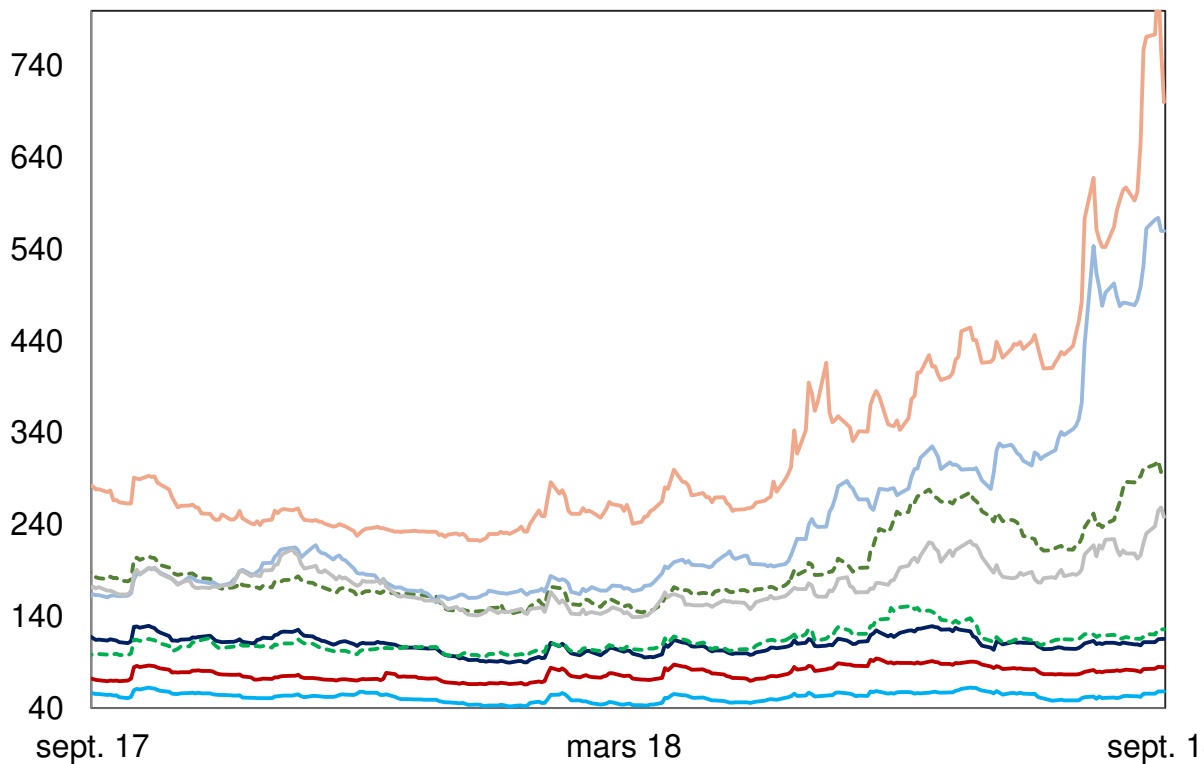
Foreign Investment Flows
Emerging markets (Billions of U.S. dollars)



Source: IIF.

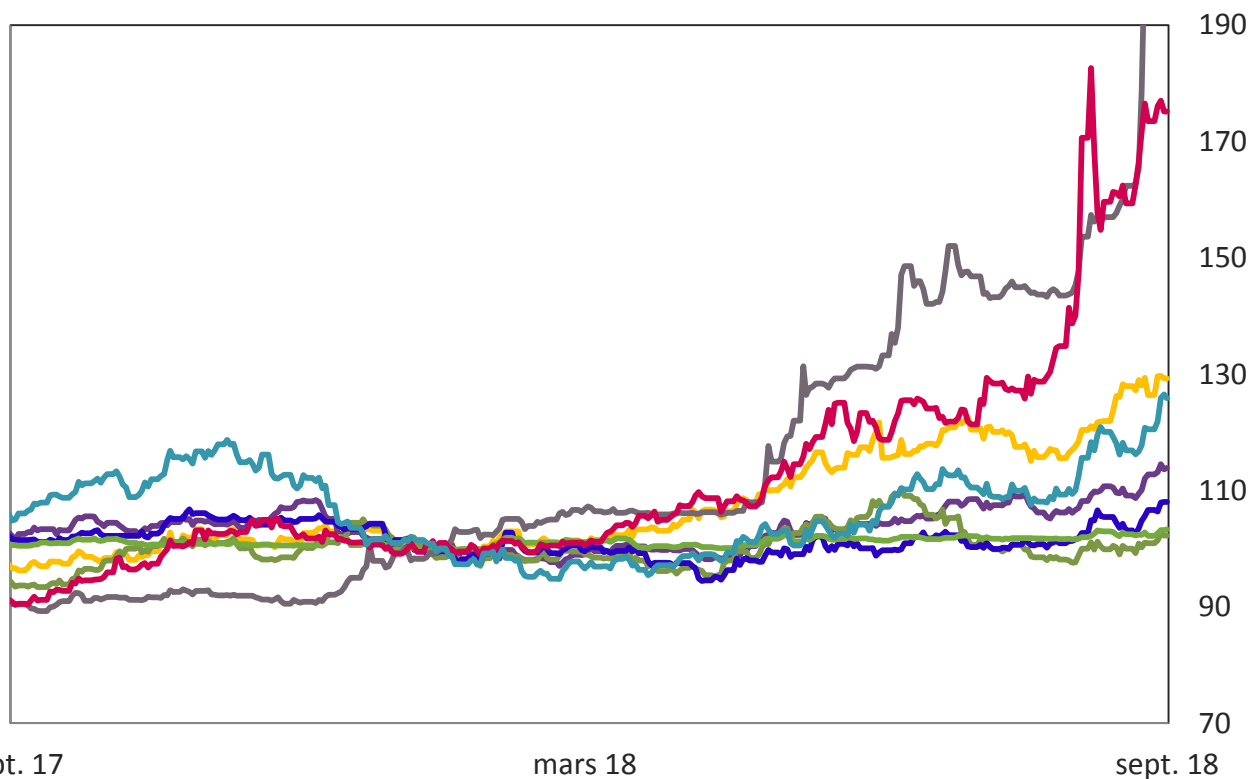
Volatility of the international financial markets have affected some emerging economies. Colombia has weathered this situation smoothly until now.

CDS Emerging Markets



Nominal exchange rate index

(Jan/2018=100) argentina



— Colombia — Brasil - - - México — Perú
 — Chile — Turquía — Argentina — Sudáfrica

— Brazil — Chile — Mexico — Colombia
 — Peru — Argentina — Turkey — Sudáfrica

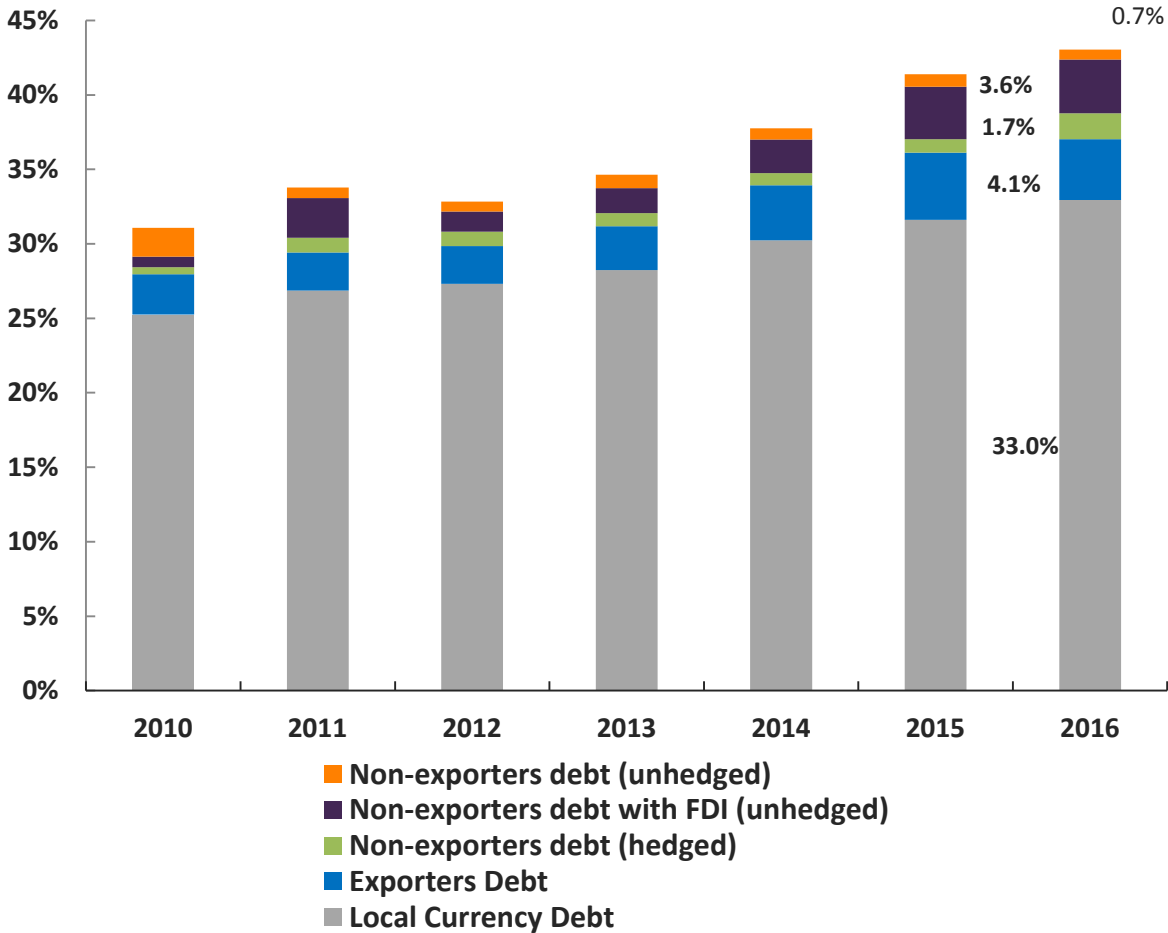
Source: Bloomberg

Policy challenges

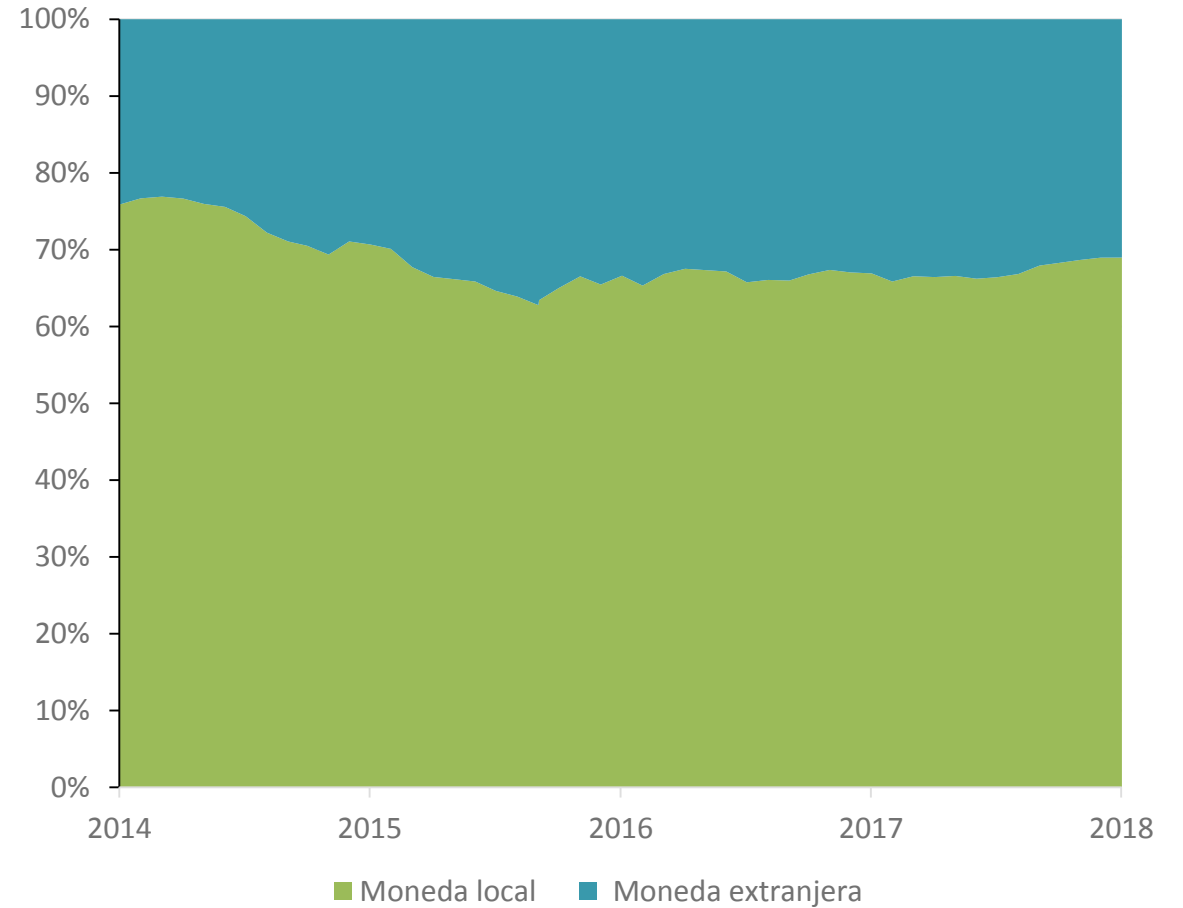
- External Risks and Policy Challenges
 - **First line of defense:** Exchange rate flexibility. But there are preconditions :
 - Limited currency mismatches (but high share of foreign investors in the public bonds market)
 - A credible monetary regime
 - Sound and robust financial sector
 - Sound fiscal policy
 - **Second line of defense:** External buffers (international reserves; Flexible credit line)

Limited currency mismatches

Debt of the Non-financial Corporate Sector (Percentage of GDP)



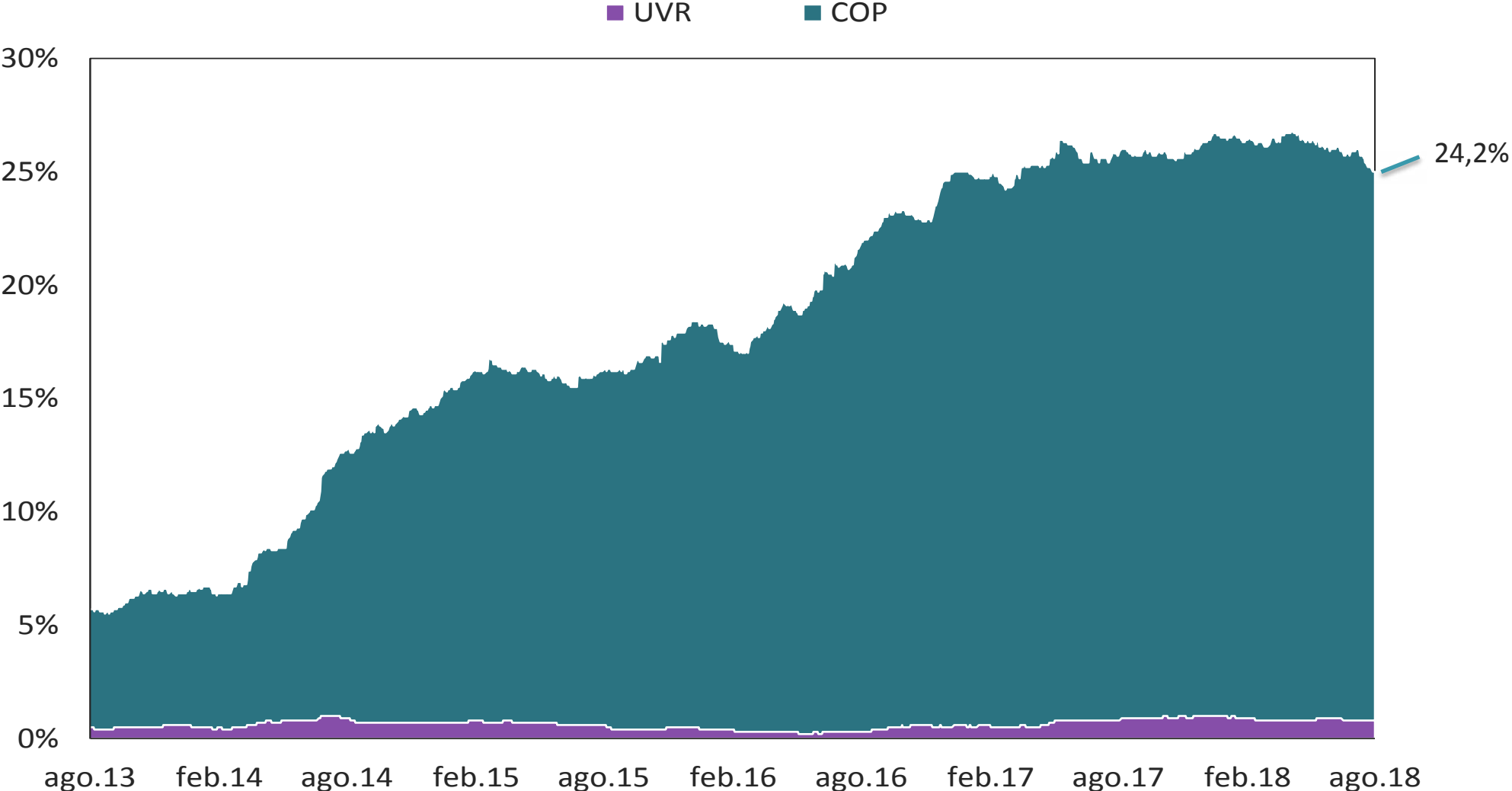
Central Government Gross debt (local vs. foreign currency) (Percentage)



***Updated results (2017) show low currency mismatches. The exposure of financial sector is limited.**

However, nearly 25% of public bonds are in the hands of foreign investors.

Share of Foreign investors in the public bonds market

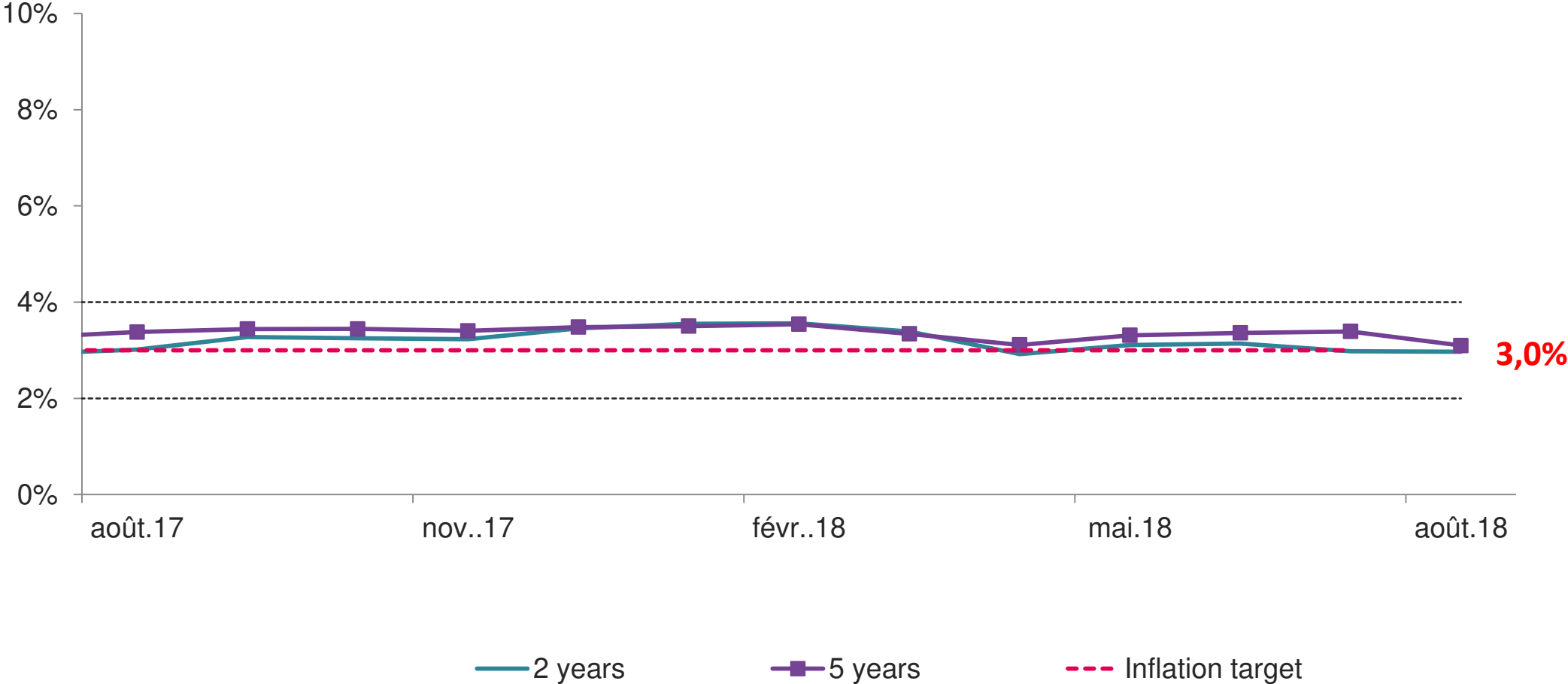


Fuente: Banco de la República – DODM.

Inflation expectations are well anchored at the 3% target

Expectations Implicit in Government Bonds (TES of 2 and 5 years)

(Percentage)

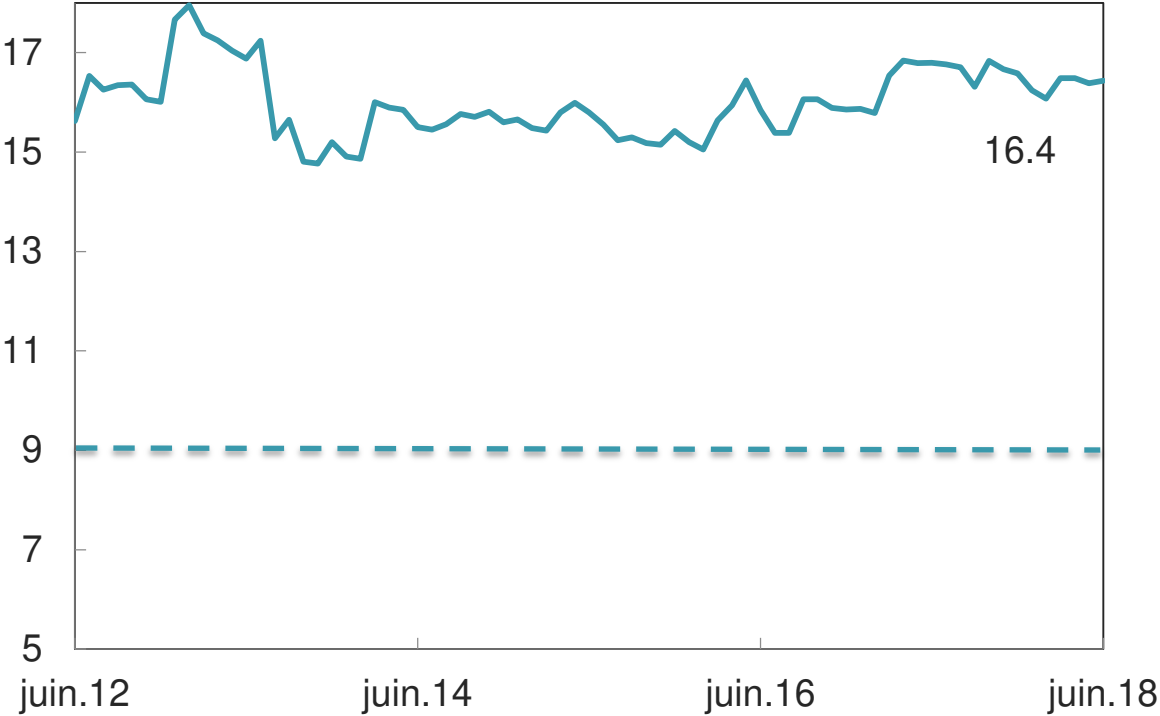


Source Fuente: Banco de la República.

Solid liquidity and solvency indicators of the banking system

Total Solvency Ratio (Tier II)

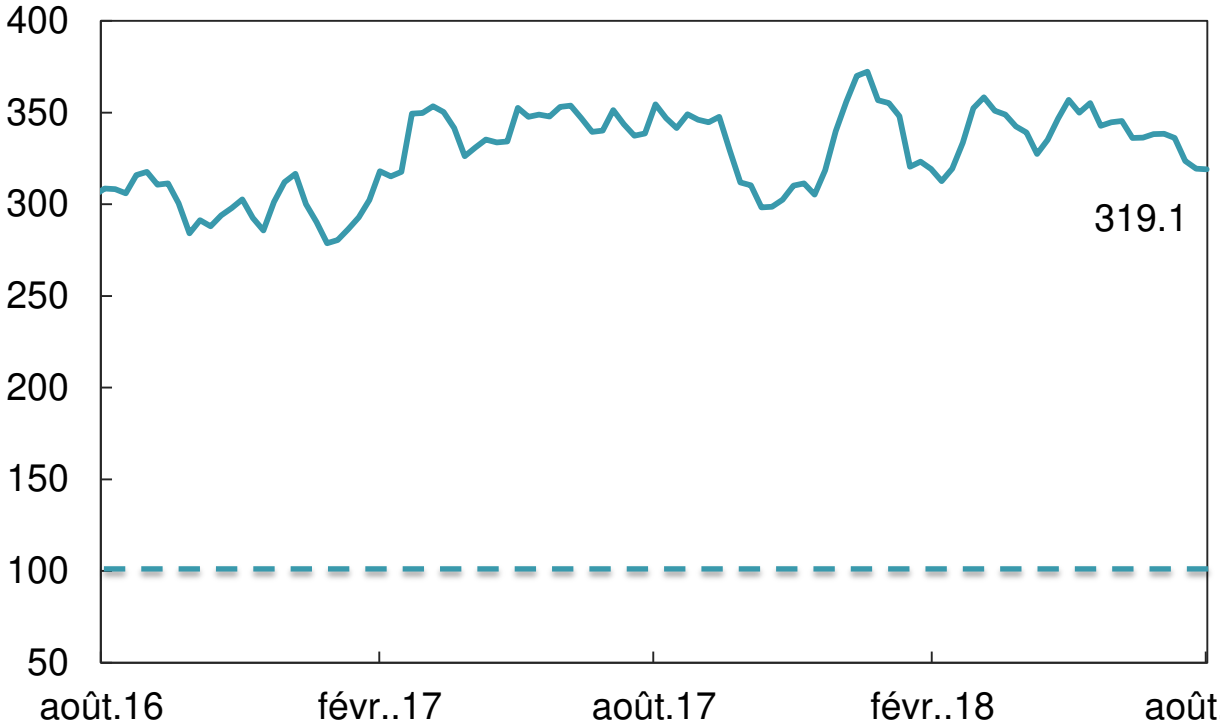
(Percentage)



Total Solvency Ratio = Technical capital / weighted assets + (11.11)*Market Risk

Liquidity Coverage Ratio (LCR)

(Percentage)

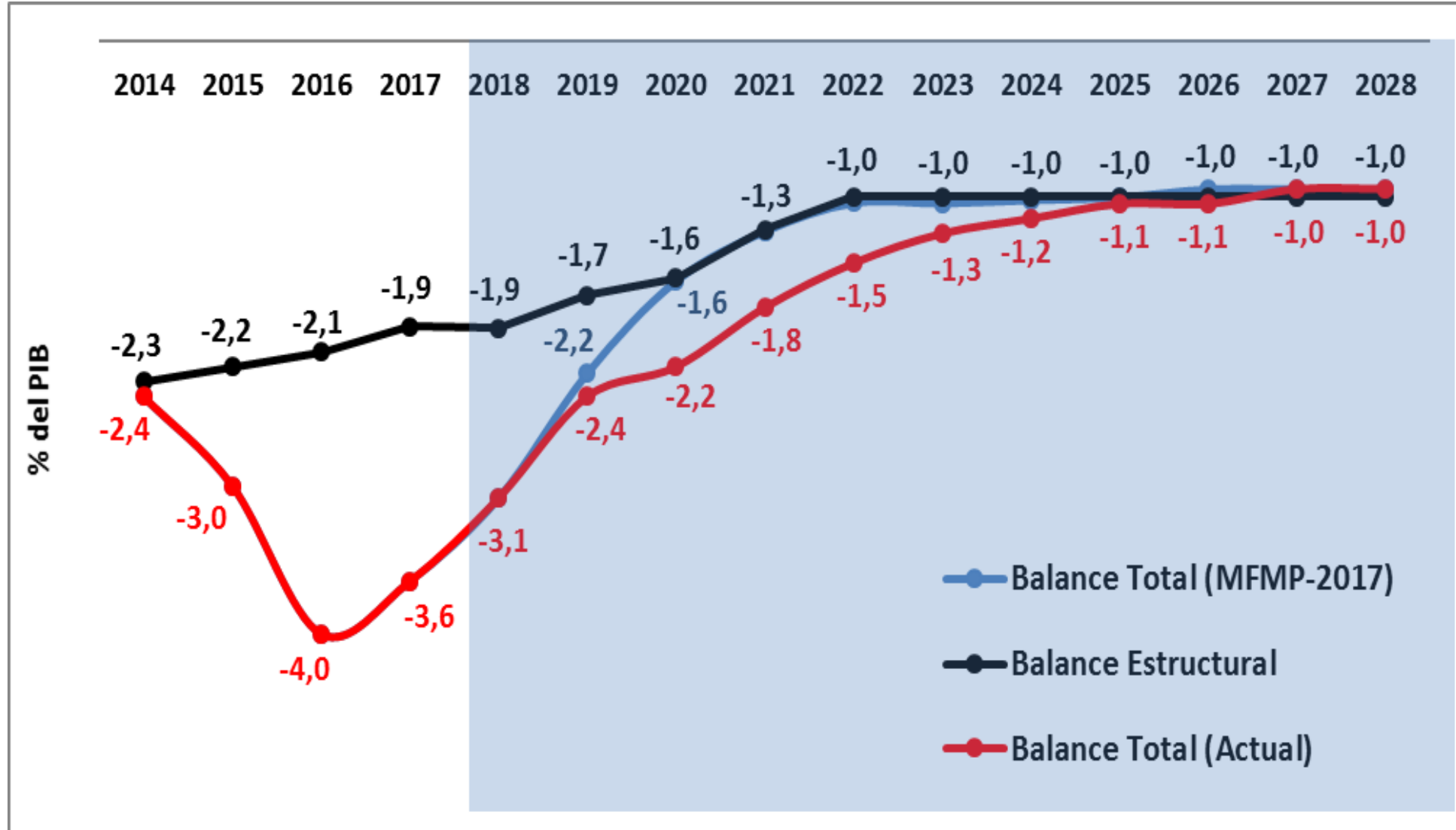


LCR= Liquid Assets / net cash outflows over the next 30 days

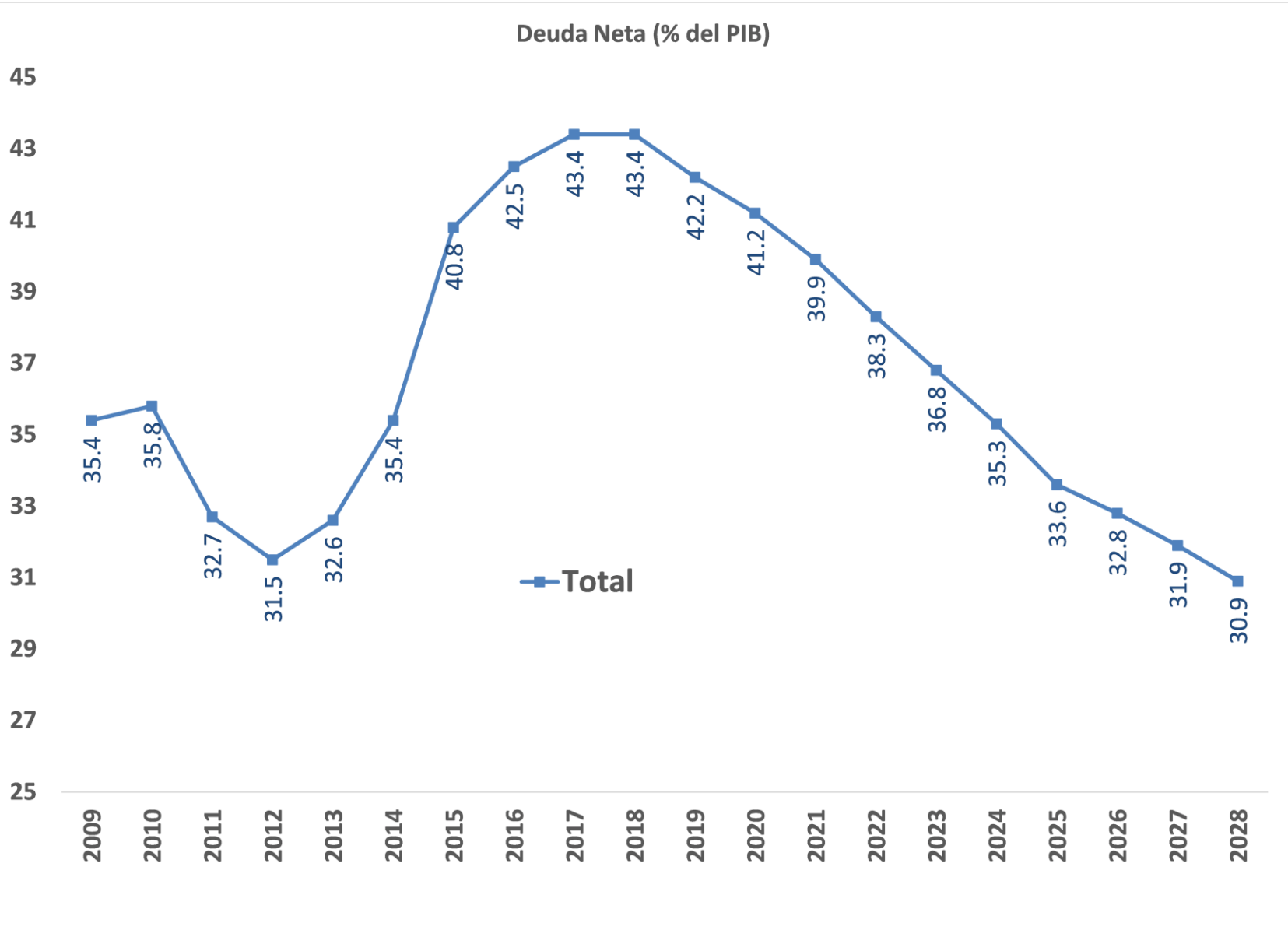
Source: Office of the Financial Superintendent of Colombia; Calculations by Banco de la República.

The Government must continue narrowing its deficit, to comply with the fiscal rule as well as reducing its debt

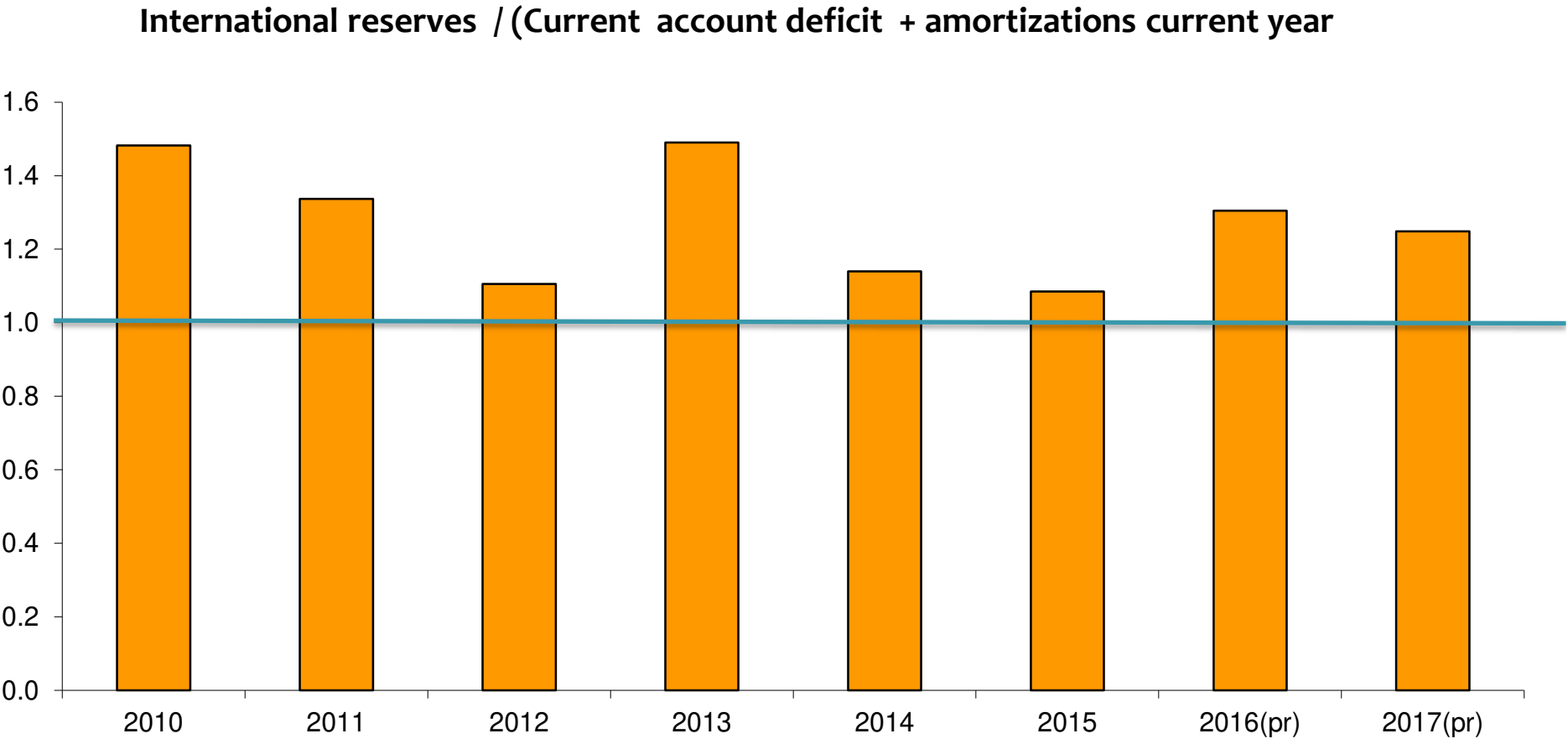
Balance total y estructural del GNC



Which will allow to reduce its total debt to safer levels.



An adequate level of international reserves provides a buffer against external shocks. The Flexible Credit Line (FCL) by the IMF has complemented the accumulation of international reserves.



Fuentes: bancos centrales, The Economist Intelligence Unit (actualización a junio de 2018) y Banco de la República

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