SOUTH AFRICA'S MONETARY POLICY AND FINANCIAL STABILITY CHALLENGES IN THE CONTEXT OF EMERGING MARKET VULNERABILITIES

ADJUSTING TO THE FALL IN OIL PRICES: THE RECENT COLOMBIAN EXPERIENCE

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Good morning,

I want to thank the South African Reserve Bank and most especially Governor Lesetja Kganyago, for the kind invitation to participate in this Conference. It is an honor and a pleasure to be here. South Africa and Colombia have confronted very similar shocks in the recent past, and I consider that from the parallels of both experiences we can draw valuable lessons for policy makers in emerging markets.

In both cases, the current macroeconomic environment has posed great challenges for monetary policy. In the case of Colombia, our economy was hit by a combination of strong shocks beginning in mid 2014, when the price of oil, our main export, began to plummet, US monetary policy has gradually tightened and the Colombian sovereign risk premium increased, raising the cost of external financing. Additionally, El Niño led to a severe drought in the second half of 2015, which strongly increased prices of food and energy. These shocks substantially affected inflation, growth, the current account balance and fiscal accounts. In this presentation, I will describe the macroeconomic effects of them and how the Colombian Central Bank reacted to this situation by designing a policy strategy that has substantially restrained inflation and moderated second round effects by controlling inflation expectations. I will also give my views on what is to be expected in the near future.

THE SHOCKS AND THEIR EFFECTS

The fall in oil prices affected the economy through multiple channels. Our terms of trade have decreased, which means that the purchasing power of our exports has declined significantly. This effect has been reflected in a reduction of our national income that has been stronger than in other Latin American, commodity-exporting countries (Figure 1). In addition to falling oil exports, the other commodity-exporting countries that are trade partners of Colombia have reduced their demand for Colombian goods (Figure 2). As a result, our non-oil exports to these markets have declined. Moreover, the profitability of mining and energy projects has fallen, so foreign direct investment in the sector has

dropped from around a quarterly average of USD 1600 m in 2014, to close to USD 900 m in 2015, and to USD 300 m in the first semester of 2016.

Likewise, given its heavy reliance on oil, public finances in Colombia have suffered significantly. Government revenues related to oil went from 2.9% of GDP on average between 2012 and 2014 to 0% currently.

Meanwhile, the Federal Reserve began the period of "normalization" in 2015. As you know, the process has been gradual, given the slow recovery of the US economy and the possibility of permanently lower growth and real interest rates in other advanced countries. Despite these mitigating factors and the expansionary stance of monetary policy in the euro area and Japan, the sovereign risk premiums of several emerging economies are greater today than in mid 2014. In the case of Colombia, the increase of the risk premium has been higher than in other countries due to the higher relative weakening of public finances after the fall of oil prices (Figure 3).

The impact of reduced oil prices in export earnings generated a significant increase in the current account deficit from previously high and rising levels (Figure 4). The fall in exports and FDI in the mining and energy sector, at the same time as the increase in the cost of external financing, caused a strong nominal and real depreciation of the Colombian peso, higher than that of other currencies in the region (Figure 5).

Although the pass-through of depreciation to domestic prices in Colombia is low, the magnitude of the depreciation was such that it had a substantial impact on consumer inflation (Figure 6). Additionally, El Niño had an effect on food prices and energy (Figure 7). The result was a sharp increase in consumer inflation, which far exceeded the 3% target set by the Board of the *Banco de la República* (Figure 8).

THE NATURE OF THE SHOCKS

In seeking the macroeconomic objective of attaining the maximum sustainable economic growth in a context of a low and stable inflation, policymakers must avoid pronounced and prolonged excesses in spending, given the risk of over-indebtedness or high inflation rates that would require a strong and costly slowdown for correction.

To achieve these goals following the strong shocks the economy has suffered, policymakers must assess the nature of these shocks. In particular, the proper policy response depends on their expected duration. The appropriate policy responses for a transient shock may be substantially different from those for a permanent shock.

In principle, the effects that currency depreciation and El Niño phenomena may have on inflation are transitory. On the one hand, in the absence of new external shocks, the exchange rate will not maintain a strong upward trend. Furthermore, the return to a 'normal' climate implies a correction of food prices (which usually come down after El Niño). However, the magnitude of the shocks and of the rise in inflation led inflation expectations at various horizons well above the target (Figure 9). This triggered indexation mechanisms (Figure 10). As a result, core inflation also increased, even those indicators that try to filter the impact that one-time depreciation has on the prices of a wide range of items in the consumer basket (Figure 11).

Accordingly, the policy response must recognize the transitory nature of rising inflation and react only to second-round effects associated with the "contamination" of inflation expectations and the activation of indexation mechanisms that prevent inflation from converging towards the target, once the effects of the shocks fade away.

The drop in oil prices is a persistent phenomenon, with a low probability of being quickly reversed. This means that the decrease in national income is durable and not merely a cyclical downturn. Therefore, spending must be adjusted; otherwise, the country will have a continued excess of expenditure over income that will need financing from international investors over a prolonged period of time. These excesses are manifested in a high and persistent current account deficit that leads to increased levels of external liabilities.

For this reason, macroeconomic policy responses must allow for a slowdown in spending that is compatible with a sustainable external balance for the country. This means that policy should not try to keep expenditure and output growth at levels observed before the shock, and this should not be treated as a temporary circumstance. The prudent thing is to equate the phenomenon to a permanent one. In other words, purely "countercyclical" policy answers are not convenient at this time.

When lower levels of international oil prices persist over time, so do the foundations of a more depreciated currency (with lower export earnings and lower foreign direct investment in the sector). Also, as long as US monetary policy is expected to tighten, a sharp reversal of the exchange rate is unlikely for the foreseeable future. Therefore, the exchange rate seems to have reached a more permanent level. In addition, the correction of the external deficit would be aided by an increase in the relative price of imported and exported goods. This can be achieved through a real depreciation of the peso; in its absence, the deficit reduction would fall completely on a contraction of spending. For these reasons, it is not desirable for economic policy to go against the exchange rate adjustment.

The above criteria have guided the policy response of the *Banco de la República* during the past two years and are an important element in defining the reaction of fiscal policy.

BANCO DE LA REPÚBLICA'S POLICY RESPONSE

Monetary policy in Colombia follows an inflation targeting strategy that seeks to keep inflation at 3%, within a range of 2% to 4%. In this context, monetary policy must ensure the convergence of inflation to the target after the effects of shocks fade away. For this purpose, the Bank's response must take into account the "second round" effects of such shocks. Without an adequate response to these effects, inflation could distance itself from the target for an extended period, raising the future cost of returning to it. So the first challenge in this regard is to determine the size and persistence of the "second round" effects.

Moreover, as I already mentioned, the *Banco de la República* must support a slowdown in economic activity, coherent with the external deficit correction. However, in the presence of price and wage rigidities, the slowdown may prove excessive. The second challenge is determining whether this is the case. Monetary policy must balance the risks of a slow convergence of inflation to the target, on the one hand, and excessive slowdown, on the other.

Considering the size of the shocks and their persistence, the Central Bank deemed it appropriate to seek convergence of inflation to the range of 2-4% in 2017. A faster convergence would have required a very sharp slowdown in the economy and a

significant cost in terms of employment. A slower convergence would entail the risk of perpetuating inflation expectations above the 3% target and further extending indexation mechanisms, excessively raising the cost of future disinflation. Consequently, the Central Bank began a cycle of raising the policy rate (Figure 15). These increases started when real interest rate levels were low, below the average since 2003 (Figure 16), and in a context in which the gap between GDP and its potential level was close to zero.

In the currency front, the policy response of the *Banco de la República* has been determined by the persistence of the oil shock and the gradual normalization of monetary policy in the United States. Such persistence implies that the new average level of nominal and real exchange rates will be lasting. For this reason, the Bank has allowed a high degree of exchange rate flexibility and sterilized intervention in the market has been minimal with sales of about USD 250 m since early 2015.

Fiscal policy response

As for the response of fiscal policy, the Fiscal Rule and the Medium Term Fiscal Framework govern fiscal policy in Colombia. They seek for the national government's structural deficit (discounting the cyclical components of GDP and oil prices) to converge gradually to 1% of GDP in 2022, and for the ratio of Government Debt/GDP to reach 31.5% in 2027. Furthermore, the institutional arrangement established that an independent commission of experts must estimate the trend value of international oil prices. For that purpose this commission has adopted a formula that combines the observed prices during the last four years with a forecast for the next four years. This feature means that, by construction, a part of the fall in oil revenue is absorbed by a cyclical increase in the fiscal deficit, which has risen by 1.5% of GDP between 2014 and 2016 (Figure 13).

However, this deficit increase is less than the reduction in oil revenues during the same period (about 3% of GDP). This means that a significant portion of the impact of the oil shock on public finances has been accommodated by adjustments in other income and spending. On the revenue side, the tax reform of 2014 increased taxation, especially by maintaining some temporary taxes (for example, the tax on financial transactions) and

the adoption of other temporary taxes (for example, the wealth tax). On the expenditure side, primary expenditure growth was adjusted, especially investment (Figure 14).

The fact that public and external deficits have increased after the shock partly explains the resilience of growth observed in Colombia. The public sector receives the bulk of income from oil, and its fall has not been fully accommodated by an adjustment in domestic demand and therefore in GDP. To the extent that this adjustment is fulfilled (for example, through higher taxes or lower primary expenditure), the external deficit should be reduced and domestic demand moderated.

Fiscal policy must complete the adjustment required to preserve a sustainable financial position and a level of real interest rates to stimulate long-term investment and growth. This involves replacing the revenues from taxes that will expire in the future, compensating the remainders of missing oil revenue, or permanently adjusting primary spending. As mentioned, this adjustment is also necessary to reduce the country's external deficit and to ease the burden that has so far fallen on monetary policy. The tax reform that will be presented in Congress this year is an essential part of this process.

MACROECONOMIC POLICY EFFECTS

Since the economy is still in a process of adjustment to macroeconomic shocks, it is too early to assess the results of these macroeconomic policy responses. However, it is possible to glimpse some of their effects. First, the response of monetary policy limited the loss of its credibility. This is inferred by comparing the dynamics of inflation and expectations at different maturities (Figures 8 and 9). The fact that expectations increased less than inflation and than measures of core inflation, suggests that economic agents understood that the direct impact of shocks on inflation would vanish and that the monetary authority would counteract the effects of "second round" to some extent. While constructing a counterfactual scenario is difficult, the above evidence suggests that in the absence of the policy response, increasing expectations would have been higher.

Second, tightening monetary policy and the fiscal policy response have contributed to the slowdown in the economy, especially in 2016. As shown in Figure 12, economic growth has slowed so far this year, coupled with a further cooling of domestic demand.

This is consistent with a partial correction of the current account deficit of the balance of payments both in dollars and as a percentage of GDP (Figure 4).

WHAT TO EXPECT GOING FORWARD

As follows from the analysis of the nature of macroeconomic shocks, the fiscal policy response must recognize the continuing deterioration of public revenue. So far, that response has included temporary tax measures and lower growth in primary spending, especially related to public investment. Therefore, an additional adjustment of public finances is necessary to completely compensate for the lost oil revenue and to maintain revenues from temporary taxes. The tax reform that will be discussed later this year is a fundamental part of this adjustment. To the extent that the sustained increase in taxation reduces private disposable income, the private sector must adjust its own spending, which will contribute to correcting the still bulging current account deficit of the country.

Meanwhile, consumer inflation began to decline in August 2016, as the effects of the shocks faded. The absence of a definite trend in the exchange rate over the last year means that no major inflationary pressures should arise through this channel. Also, as has previously occurred after strong El Niño phenomena, the end of the most recent episode anticipates the reversal of the increase in relative food prices registered since last year. Onward, then, inflation should gradually converge to the 3% target.

In this context, the speed of that convergence and the pace of the slowdown in economic activity will determine the stance of monetary policy going forward. The Bank's objective is to bring inflation within the range of 2-4% in 2017 and reach the target of 3% henceforth.

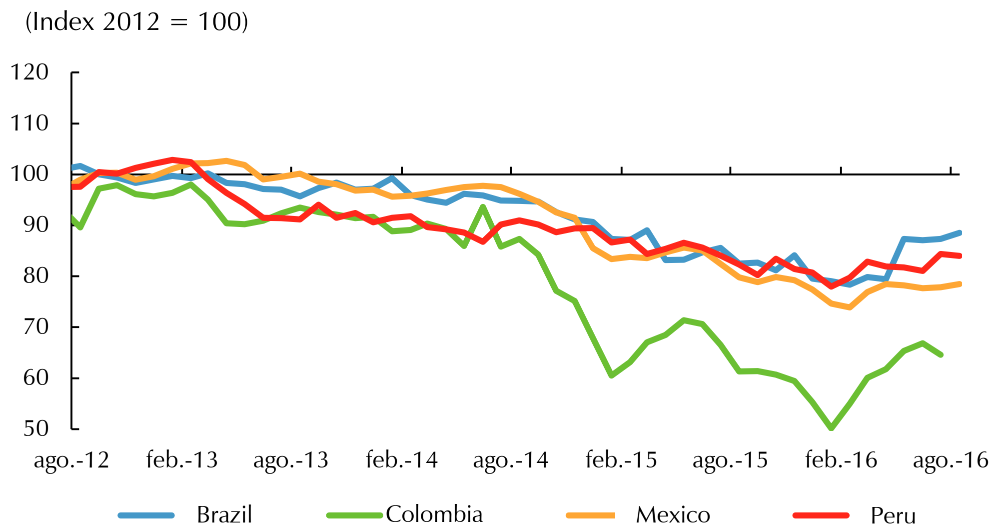
The perspectives of monetary policy are also conditioned by external events that are difficult to predict. In particular, the future course of monetary policy in the US and the anticipation of this from capital markets may substantially affect the exchange rate and financial conditions of the economy. This is a risk that should not be underestimated.

Finally, the aforementioned consolidation of the fiscal adjustment will produce a better mix of monetary and fiscal policy. The existence of a lower path of national income requires a permanent response of domestic demand. This is accomplished with tax

measures that affect disposable income or spending permanently, rather than changes in the interest rate that essentially postpone consumption or investment, but do not significantly alter their level. That is why the correction of the external deficit is achieved sustainably through fiscal policy rather than monetary policy. To top it off, an adjustment in domestic demand brought about by fiscal policy facilitates the return of inflation to the target and reduces the burden on monetary policy.

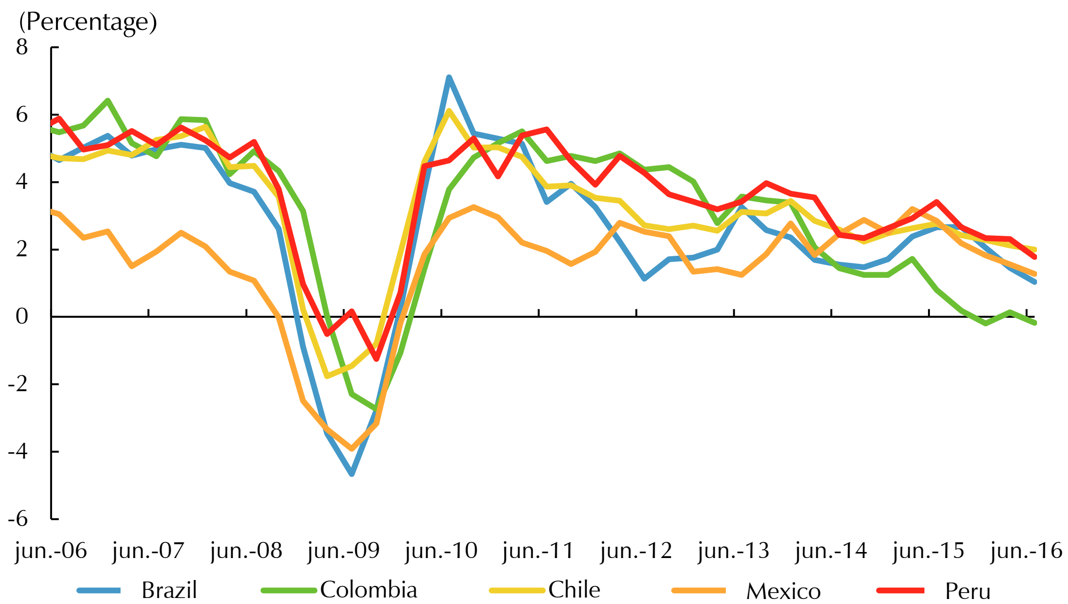
I hope this review of Colombia's recent macroeconomic policies help to enrich the discussion. Thank you.

FIGURE 1. TERMS OF TRADE



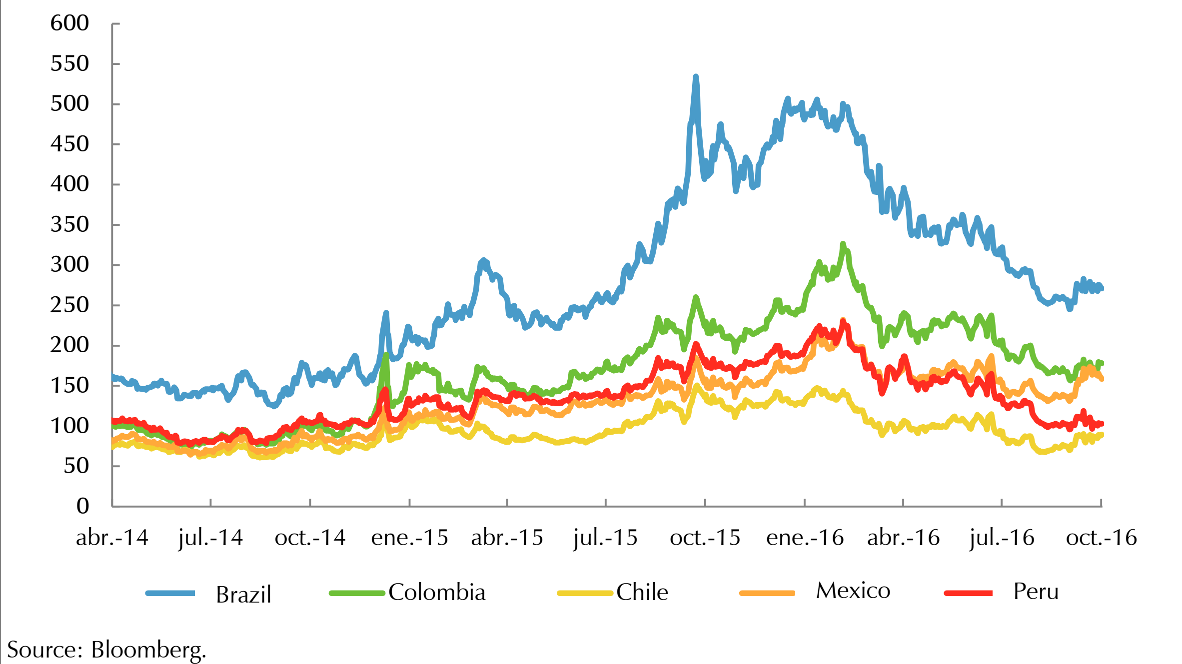
Source: Datastream.

FIGURE 2. AVERAGE GROWTH OF TRADING PARTNERS



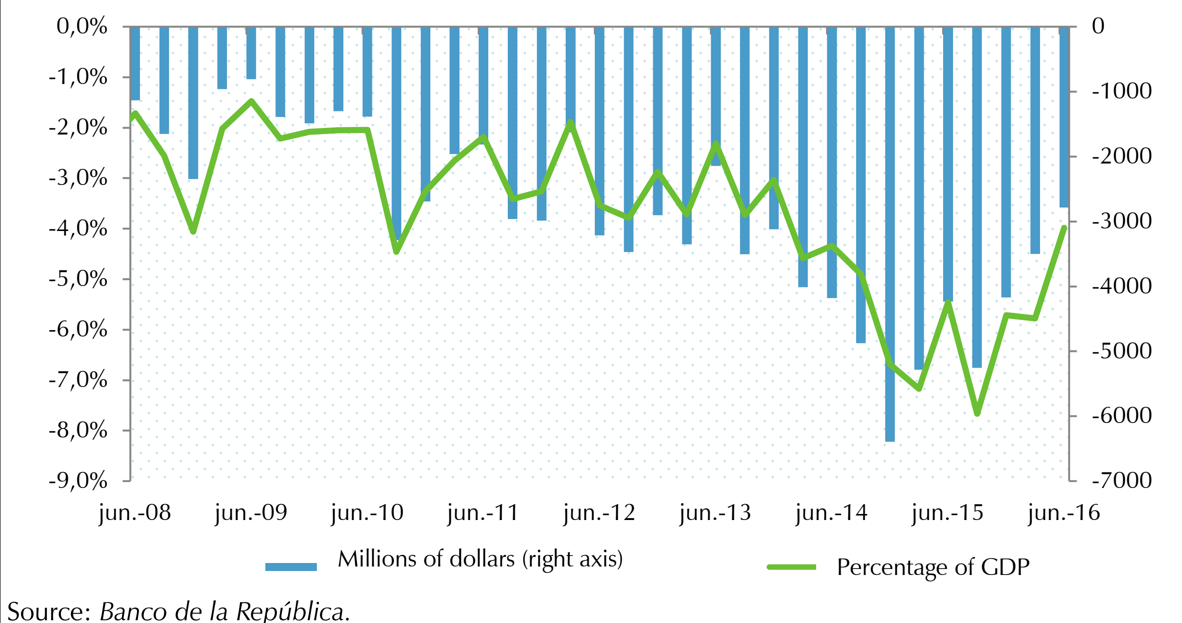
Source: Datastream; United Nations (Trade Database - UN Comtrade).

FIGURE 3. 5-YEAR CDS



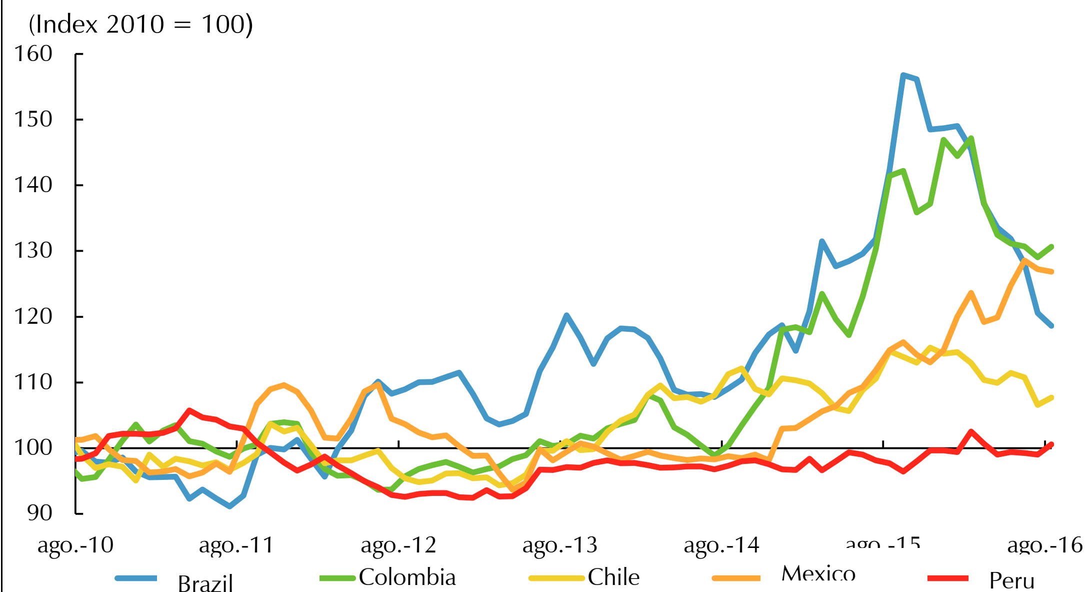
Source: Bloomberg.

FIGURE 4. COLOMBIAN CURRENT ACCOUNT DEFICIT



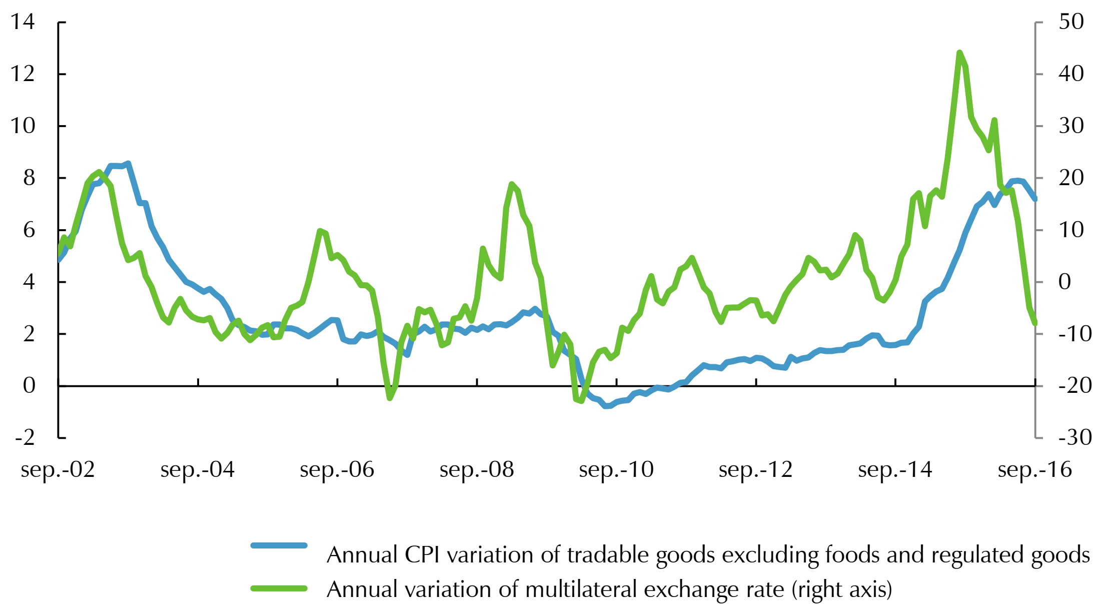
Source: *Banco de la República*.

FIGURE 5. REAL EXCHANGE RATE



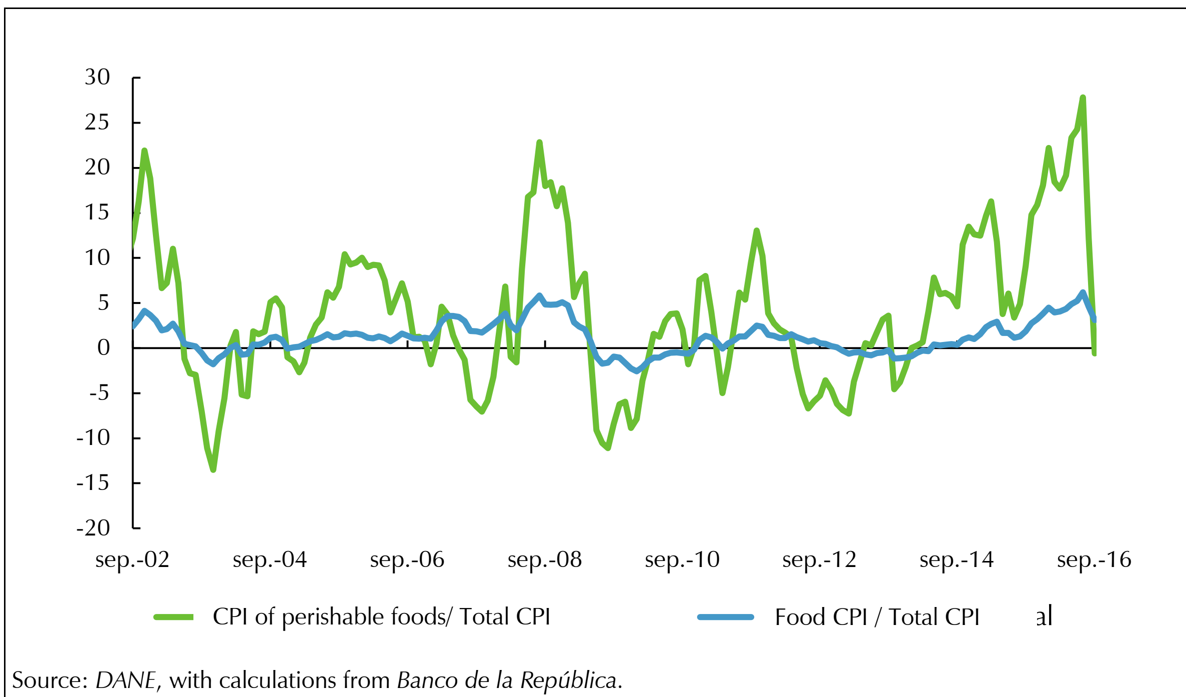
Source: Datastream.

FIGURE 6. MULTILATERAL ANNUAL NOMINAL DEPRECIATION AND ANNUAL CHANGE IN TRADABLES EXCLUDING FOOD AND REGULATED GOODS (%)



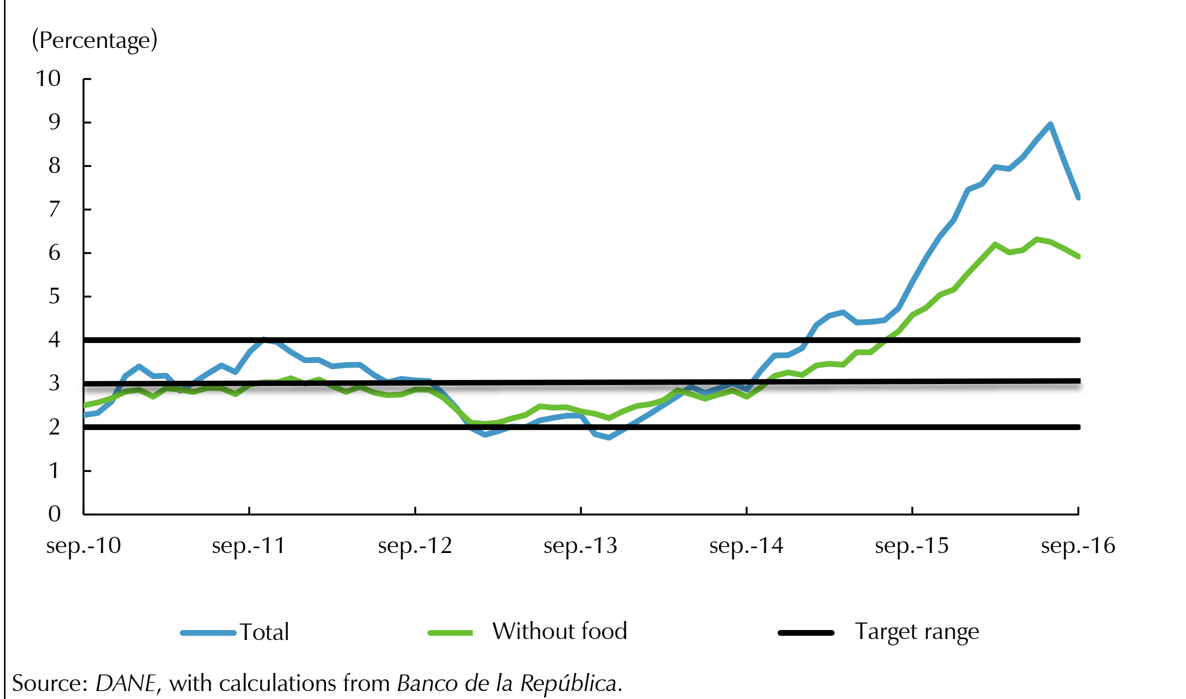
Source: *DANE*, with calculations from *Banco de la República*.

FIGURE 7. CHANGES IN RELATIVE FOOD PRICES (%)



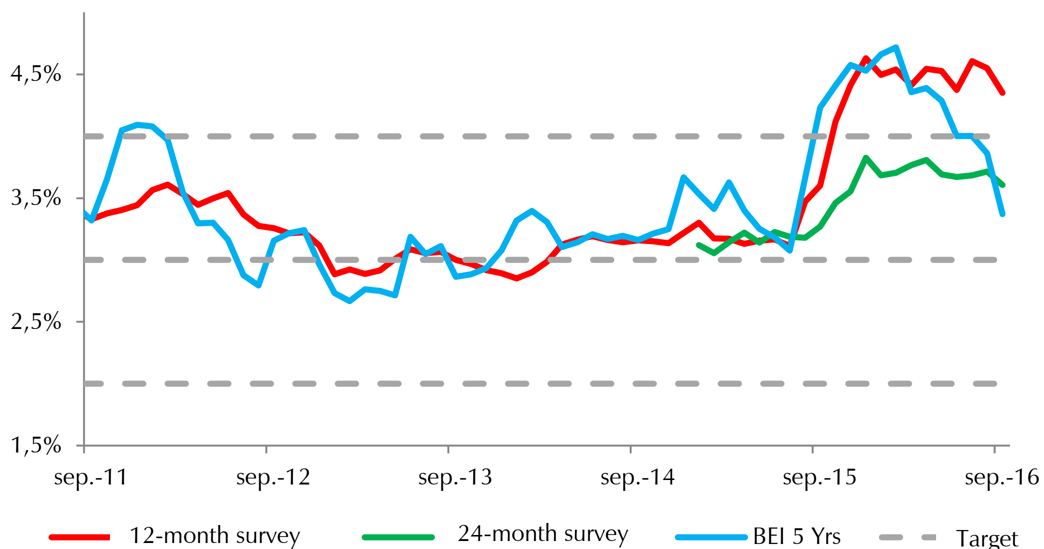
Source: *DANE*, with calculations from *Banco de la República*.

FIGURE 8. CPI INFLATION AND TARGET



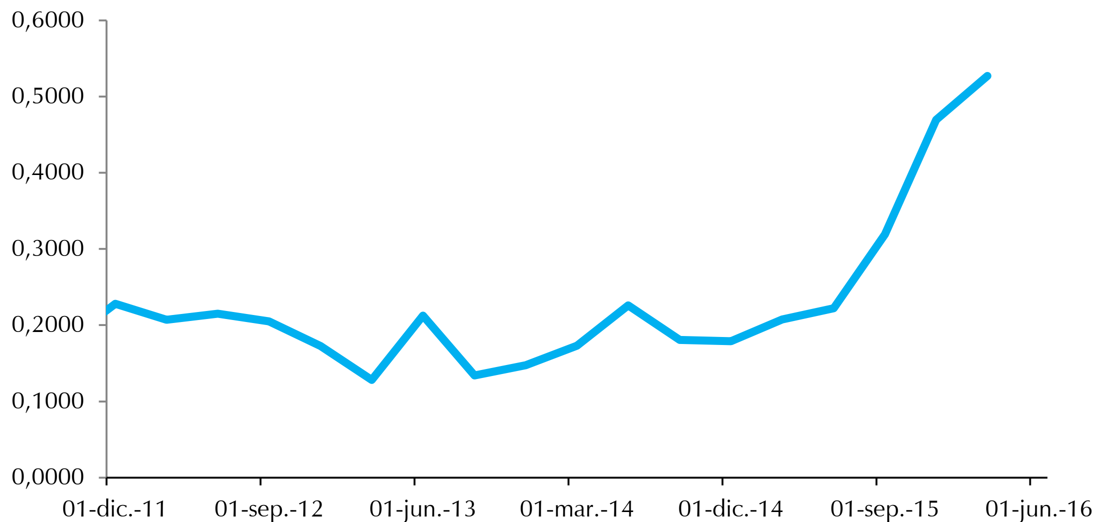
Source: *DANE*, with calculations from *Banco de la República*.

FIGURE 9. INFLATION EXPECTATIONS



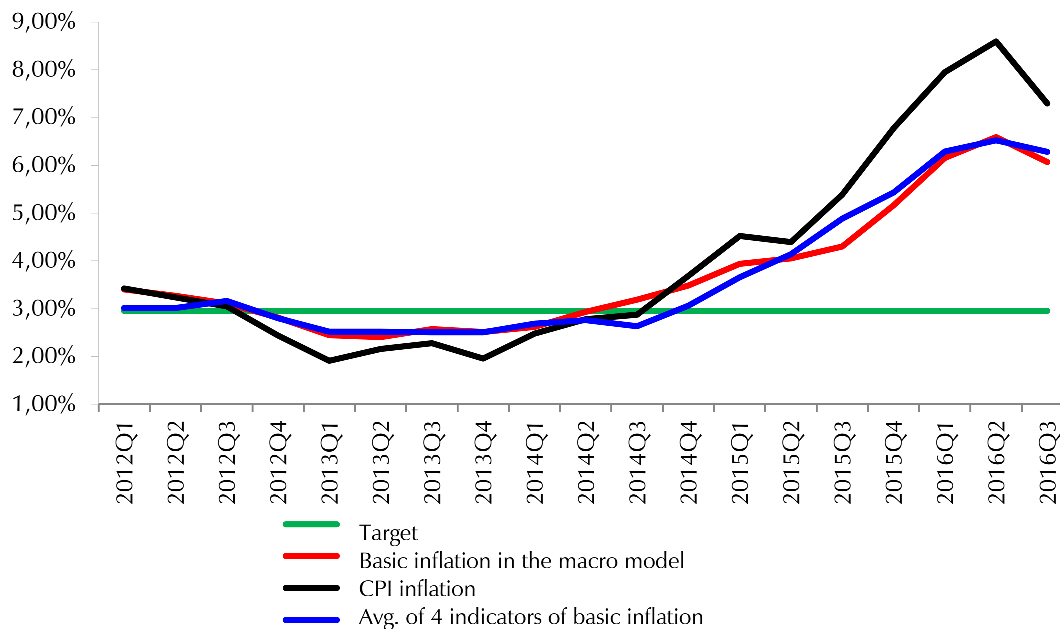
Source: DANE and Banco de la República.

FIGURE 10. IMPORTANCE OF PREVIOUS INFLATION IN DETERMINING CURRENT INFLATION



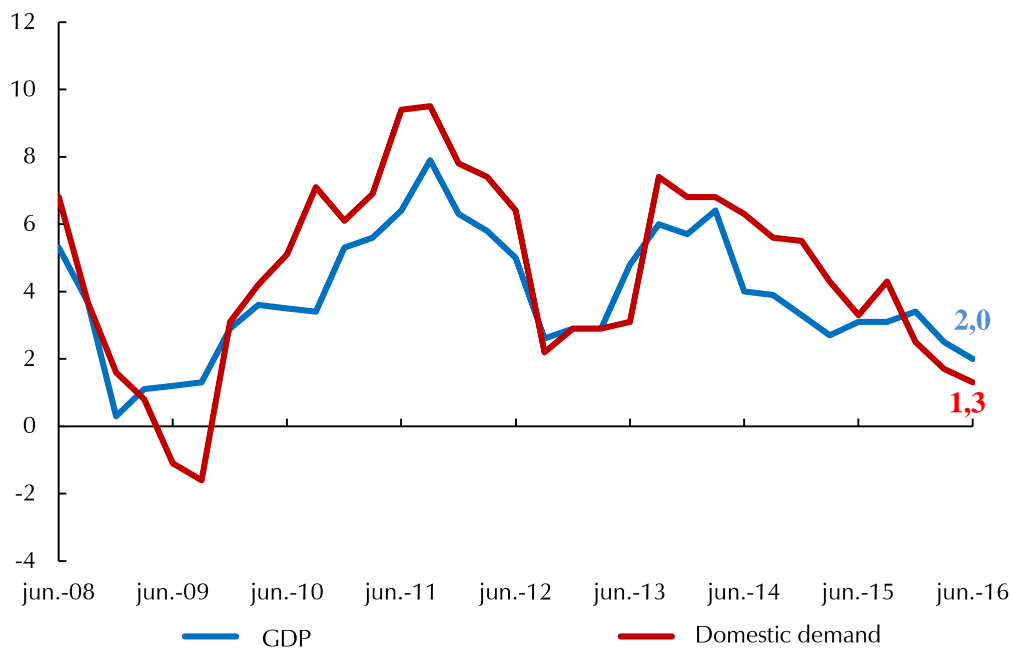
Source: Rodríguez, D. "Dinámica de la persistencia de la inflación". Mimeo, *Banco de la República*. July, 2016.

FIGURE 11. CPI INFLATION AND CORE INFLATION MEASURES



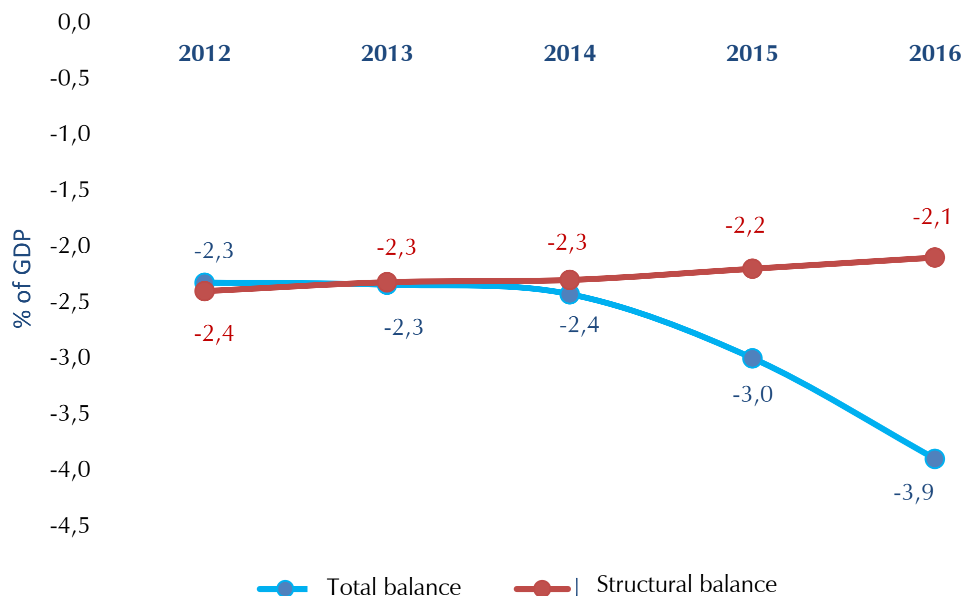
Source: *DANE* with calculations from the *Banco de la República* based on Bejarano et al, "Indicador de inflación básica a partir de un modelo semi-estructural con inflación de alimentos". Borradores de Economía No. 935, Banco de la República, marzo de 2016.

FIGURE 12. ANNUAL GDP GROWTH AND DOMESTIC DEMAND (%)



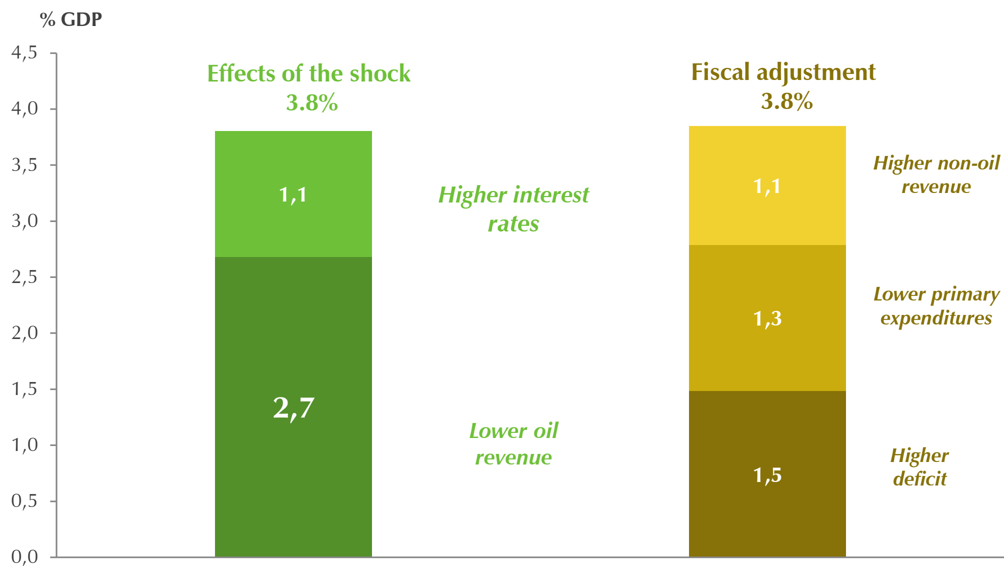
Source: *DANE*.

FIGURE 13. STRUCTURAL NATIONAL GOVERNMENT DEFICIT



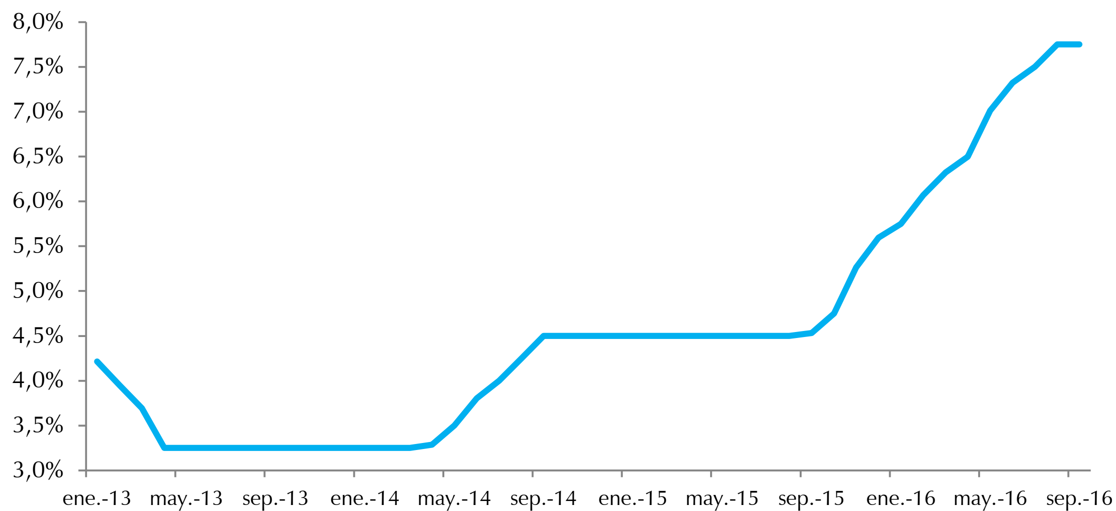
Source: *Ministerio de Hacienda y Crédito Público.*

FIGURE 14. EFFECTS OF THE OIL SHOCK AND FISCAL ADJUSTMENT MEASURES 2014-2016



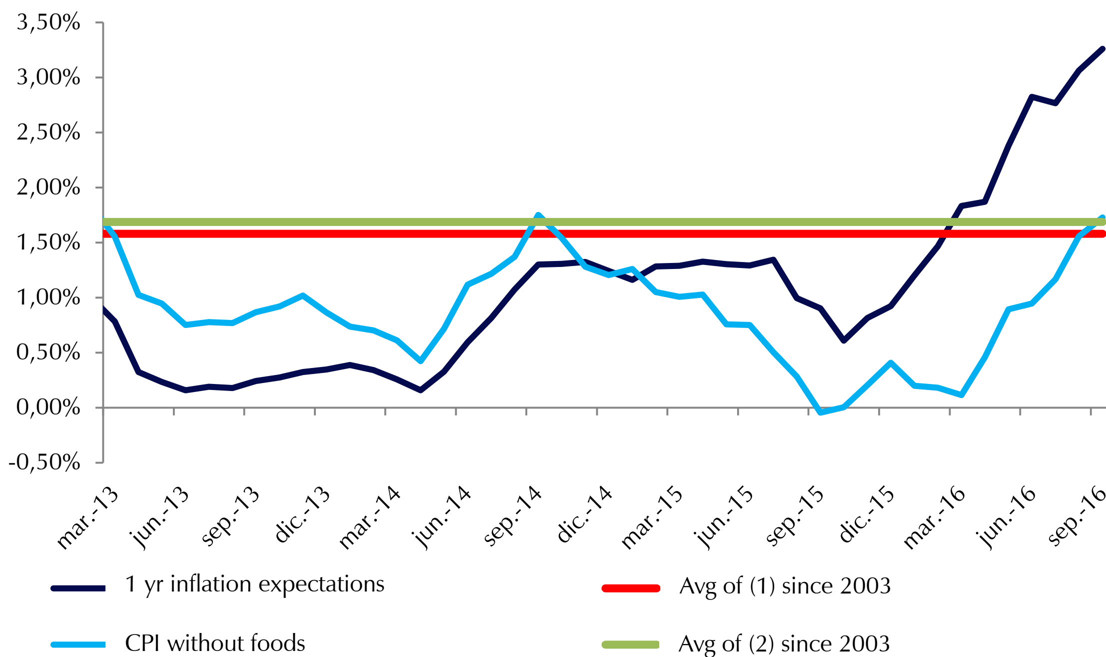
Source: Calculations by *Banco de la República*, based on data from the MHCP

FIGURE 15. POLICY INTEREST RATE



Source: *Banco de la República.*

FIGURE 16. REAL POLICY INTEREST RATE LEVELS (NOMINAL RATE DEFLATED WITH VARIOUS MEASURES OF INFLATION)



Source: Calculations by *Banco de la República*.