Emerging Insight

Colombia – Premature cuts impair transmission channels of monetary policy

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Key takeaways

- We believe the tightening cycle in Colombia is over. Policymakers seem to be under social pressure to cut rates.
- Premature rate cuts would risk impairment of monetary transmission channels: rates, exchange rate, credit, expectations.
- LDM strategy: High-for-longer outlook provides opportunity to enter flatteners. We like 1s5s IBR flatteners.

By A. Müller, C. Gonzalez Rojas and A. Gabriel

Chart of the Day: BofA's inflation forecast for April 2023 (CPI data to be released on 5 May)
Government continues hiking gasoline prices. Excise tax on "unhealthy food" will go up in Nov 2023

Apr-23	Weight in CPI (%)	Variation (% mom)	Notes
Energy	6.9	2.27	Increase in gasoline prices (401 pesos, +3.72% mom). Electricity prices up 1.25% mom (sample: ENEL, EPM)
Food	15.05	0.85	*SIPSA wholesale food price survey shows food inflation around 0.75% mom. Large increase in fish prices, associated to Easter holidays. President Petro announced agreement with business associations (ANDI and SAC) to lower food prices.
Core (CPI excluding energy & food)	78.05	0.68	Easter holidays bid up transport prices, air tickets, hotels & tourism services. Higher food prices contaminating restaurant prices. Minimum wage pressure. Housing rent indexation
CPI	100	0.83	

Source: BofA Global Research, Statistics Institute (DANE). *Note: Our measure of SIPSA survey includes a subset of items and markets.
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Colombia in Focus

A social goal hidden in BanRep's reaction function

A consensus view in the market is that the Central Bank of Colombia (BanRep) has been less hawkish than it should be, facing what are arguably the nastiest inflation dynamics among the LatAm countries where monetary policy is conducted under an inflation targeting regime (Bra, Mex, Col, Chi, Per, DR, CR, Gua, Hon, Par, Uru). The "Tinbergen rule" – named after the 1969, Nobel laureate, Dutch economist, Jan Tinbergen – says that a central bank must have at least one policy instrument for each policy goal.

In Colombia the central bank's mandate is focused on inflation. But their verbal guidance over the years has made it clear they also care a lot about economic growth and financial stability. Adding a "social goal" into the mix could call into question the framework's credibility.

This may sound like an exaggeration. But the fact is markets are pricing in rate cuts for Colombia as early as 3Q2023 (Exhibit 2), even though inflation is running at 13% and inflation expectations are completely de-anchored. The pricing-in of premature policy rate cuts, in our view, is a manifestation that the market thinks some kind of "social goal" is being incorporated into the central bank's decision framework.

Exhibit 1: BofA's inflation forecasts for Colombia (%)

We believe headline inflation will still be well-above the Central Bank's 3% target by the end of 2024

	CPI		Core (CPI ex food & energy), DANE measure		Food (food & non-alcoholic beverages)		Energy (electricity, residential gas, fuel for transportation)	
Weight (%)	100.00		78.05		15.05		6.90	
Period	mom	yoy	mom	yoy	mom	yoy	mom	yoy
Dec-21	0.73	5.62	0.33	2.84	2.07	17.23	1.66	10.20
Jan-22	1.66	6.94	1.17	3.84	3.79	19.94	1.73	11.75
Feb-22	1.63	8.00	1.25	4.42	3.26	23.29	1.60	12.99
Mar-22	1.00	8.53	0.60	4.76	2.84	25.37	0.42	11.35
Apr-22	1.25	9.23	0.86	5.44	2.75	26.18	1.44	11.36
May-22	0.84	9.06	0.63	5.99	1.56	21.60	1.20	12.10
Jun-22	0.51	9.68	0.38	6.22	0.64	23.64	1.44	13.66
Jul-22	0.80	10.20	0.57	6.52	1.17	24.62	2.28	15.56
Aug-22	1.02	10.84	0.71	6.96	1.85	25.56	2.04	17.34
Sep-22	0.93	11.44	0.69	7.42	1.61	26.62	1.52	18.17
Oct-22	0.72	12.22	0.53	8.24	1.21	27.02	1.23	19.03
Nov-22	0.77	12.53	0.58	8.61	1.49	27.08	0.71	18.67
Dec-22	1.26	13.12	0.90	9.23	2.66	27.81	0.98	17.88
Jan-23	1.78	13.25	1.61	9.71	2.47	26.18	1.62	17.75
Feb-23	1.66	13.28	1.65	10.15	1.59	24.14	1.84	18.03
Mar-23	1.05	13.34	0.95	10.53	0.91	21.80	2.54	20.52
Apr-23	0.83	12.87	0.68	10.34	0.85	19.55	2.27	21.51
May-23	0.55	12.55	0.48	10.17	0.34	18.13	1.83	22.27
Jun-23	0.37	12.40	0.45	10.25	-0.13	17.22	0.93	21.66
Jul-23	0.37	11.91	0.35	10.01	0.14	16.03	1.14	20.30
Aug-23	0.31	11.12	0.29	9.54	0.03	13.96	1.31	19.43
Sep-23	0.43	10.58	0.37	9.19	0.35	12.55	1.30	19.18
Oct-23	0.28	10.10	0.27	8.92	-0.05	11.14	1.22	19.17
Nov-23	0.45	9.76	0.31	8.63	0.69	10.27	1.19	19.74
Dec-23	0.53	8.96	0.51	8.20	0.31	7.75	1.23	20.04
Jan-24	1.26	8.41	1.35	7.92	1.05	6.25	1.00	19.31
Feb-24	1.16	7.88	1.38	7.63	0.35	4.95	1.19	18.55
Mar-24	0.70	7.50	0.63	7.30	0.81	4.85	1.07	16.85
Apr-24	0.51	7.16	0.33	6.92	1.00	5.01	0.98	15.37
May-24	0.37	6.96	0.33	6.76	0.25	4.92	1.01	14.45
Jun-24	0.25	6.83	0.35	6.64	-0.22	4.82	0.50	13.96
Jul-24	0.26	6.72	0.25	6.53	0.05	4.73	0.90	13.69
Aug-24	0.13	6.52	0.18	6.42	-0.06	4.63	0.10	12.33
Sep-24	0.25	6.32	0.26	6.31	0.26	4.54	0.11	11.01
Oct-24	0.13	6.16	0.19	6.22	-0.14	4.44	0.20	9.89
Nov-24	0.15	5.84	0.20	6.11	-0.06	3.67	0.20	8.82
Dec-24	0.37	5.68	0.40	6.00	0.24	3.59	0.39	7.91

Source: BofA Global Research, Statistics Institute (DANE)

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5 ways in which premature cuts can impair transmission

1. Interest rate channel: the syndrome of the "dog chasing its own tail"

2.

The idea is that the weaker the inflation-fighting credibility of a Central Bank, the more inflation it will fan when cutting rates. At an extreme, a central bank that cuts rates – amid poorly-anchored inflation expectations – can trigger a higher real rate (equal to the nominal rate minus 12-month inflation expectations). This is the opposite of the desired outcome. Or at least, be forced to do more cuts to make monetary conditions more accommodative, which would result in a very inefficient easing cycle.

3. **Exchange rate channel: throwing sand into pistons of real exchange rate**

4. Unlike in the Central American inflation-targeters, financial and transactional dollarization in Colombia is insignificant. There are barely any negative balance sheet effects associated with COP depreciation. This means a weaker exchange rate, induced by rate cuts, is more likely to – unambiguously – stimulate economic activity. However, that conclusion changes in the face of inflation instability. If rate cuts put upward pressure on inflation, the real exchange rate[1] might not adjust to an extent that makes a difference for activity. In fact, if there is an inflationary pyre and the real exchange rate ends up appreciating, as a result of the rate cuts, that would be negative for activity.

5. **Credit channel: inflation instability is conducive to credit scarcity**

6.

Inflation instability is poisonous for credit markets. For example, in Colombia's southern neighbor Peru, as late as in the early 2000s there were no local currency-denominated banking loans with periods longer than 1 year. No mortgages or long-term credit for corporates or SMEs (small & medium-sized enterprises), other than in US dollars. In our view, it was inflation-targeting (and the hard-earned anti-inflation credentials of the central bank) what transformed Peru's credit market into what it is today. Likewise, it is no coincidence that, according to the World Bank's latest data, Argentina's credit to the private sector is less than 20% of GDP. That is less than one-third of the LatAm & Caribbean average. People become fearful of saving in local currency. Banking deposits are stunted. Put simply, tolerating high inflation for longer could negatively impact Colombia's credit market.

7. **Expectations channel: reduced capacity to influence long-term interest rates**

8.

The monetary policy tool known as "forward guidance" is based on the idea that what really matters for the economy are long-term interest rates (mortgages, auto loans, education loans, long-term loans for corporates, entrepreneurships, etc.), not short-term rates. Long-term rates are what drive the economic cycle, and they are a function of the expected path of short-term interest rates (which are shaped by the central bank). The point is that an inflation-targeting central bank that deviates from its mandate – for reasons that are not fully transparent, even if temporarily – runs the risk of suffering a credibility problem, and thus reduced capacity to influence expectations.

9.

Janet Yellen's words are illuminating. In 2013, when Yellen was Vice Chair of the Fed, she said, *"When the FOMC pushes the federal funds rate up or down, other short-term interest rates normally move in tandem. Medium- and longer-term interest rates,*

[1] The real exchange rate (Q) is defined as the nominal exchange rate (USDCOP) multiplied by the foreign CPI (weighted average of trading partners), divided by Colombia's CPI. Holding everything else constant, higher inflation in Colombia makes the real exchange rate appreciate and Colombia to lose cost-competitiveness vis-à-vis trading partners.

including auto loan rates and mortgage rates, generally adjust also, through a mechanism I will return to in a moment [forward guidance]."[2] Then, in 2018, during a conference organized by Brookings, she argued, *"Under the empirically reasonable assumption that what matters for aggregate spending is the entire expected path of short-term rates rather than just the current level, [forward guidance] enables the Fed to provide substantial additional accommodation during zero lower bound episodes".*[3]

10. Portfolio rebalancing channel: inflation instability messes up relative prices

11. BanRep is buying local currency government bonds (TES). Back in 2020, they did it with an explicit message of delivering Quantitative Easing (QE). Now they argue the policy of TES purchases is just part of their monetary operations, so liquidity in the economy grows in lockstep with money demand. Regardless of that, QE is part of BanRep's toolbox. In the future, if inflation instability exacerbates that would damage the transmission of QE. QE has two main transmission channels: expectations and portfolio rebalancing.

Expectations, using the signalling of policy intentions to influence parts of the yield curve that are beyond the reach of the (short-term) policy rate. And portfolio rebalancing, given that financial institutions that sell TES to BanRep will then need to rebalance their portfolios by purchasing other assets. TES and cash are imperfect substitutes. Therefore, it is likely that financial institutions will purchase other assets (equities, corporate bonds, real estate funds, etc.).

Our point is inflation instability distorts the relative prices (and investment returns) across sectors in the economy. For example, non-tradable sectors (like domestic-oriented manufacturing) could look more profitable than they really are, because of higher final goods prices and an appreciated real exchange rate, perhaps luring investors into putting more money into this sector, for the wrong reasons.

BofA scenario: No hike in April, but no cuts in 2023

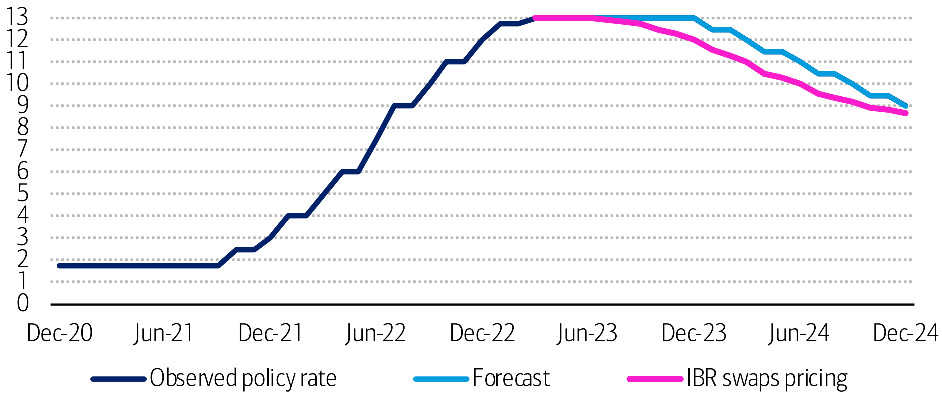
We interpret BanRep policymakers' most recent verbal guidance as leaning in the dovish direction. Last week, Bloomberg published a news article quoting board member Steiner, who is generally viewed as the most hawkish individual on the board. He said that BanRep cannot imitate Brazil's monetary policy where inflation is too high although inflation has fallen. In the same vein, during the press conference of the last meeting (March), Governor Villar did not rule out the possibility of rate cuts in 2023, when asked by a journalist. And Finance Minister Ocampo, who also votes on BanRep's seven-member board, has been stressing some "encouraging inflation trends".

In our view, BanRep's tightening cycle is over. We expect them to maintain the policy rate at 13% at the next meeting (28 April), shrugging off the inflation surprise in March. Nevertheless, we believe they will begin the normalization (easing) process later (January 2024) than expected by the market (Q3, see Exhibit 2).

[2] See http s://www.federalreserve.gov/newsevents/speech/yellen20130404a.htm.
[3] See http s://www.brookings.edu/blog/up-front/2018/09/14/comments-on-monetary-policy-at-the-effective-lower-bound/.

Exhibit 2: Policy rate forecasts (%)

We expect the first cut to happen next January (50bp), and then 50bp in every meeting of 2024



Source: BofA Global Research, Central Bank (BanRep)

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LDM: Prepare for high-for-longer

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Inflation is sticky in Colombia

Colombia has arguably the stickiest inflation in LatAm. Unlike the rest of the region, core inflation in Colombia has not yet peaked on the back of high levels of indexation, the gradual withdrawal of fuel subsidies and a still overheated economy (Exhibit 3). Even if there is some downward pressure stemming from a more benign global backdrop (e.g., declining food prices), we have argued that Colombia has the most severe domestic inflation problem in the region (see Common drivers of uncommon inflation).

Dovish BanRep guidance = lower peak, high rates for longer

A strong economy and sticky inflation would normally be conducive to a more hawkish central bank. Yet, guidance from BanRep suggests that the central bank could end the cycle at the upcoming meeting. As such, our baseline is that BanRep will most likely remain on hold in its April 28 meeting. Still, we acknowledge that risks to our view are most likely to the upside, given the sticky inflation outlook in Colombia. The market is pricing one last 25bp hike with low conviction.

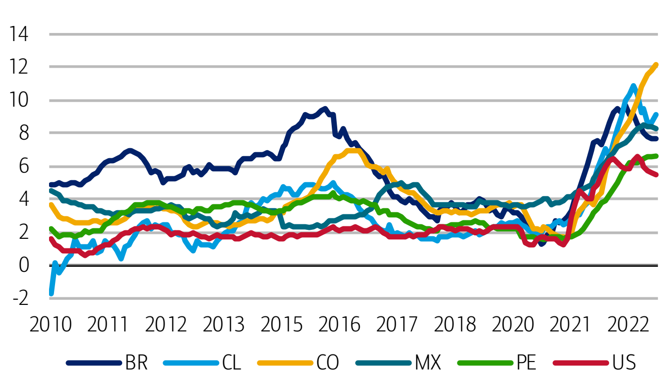
However, we disagree with the market expectation that BanRep will be able to cut rates as soon as September (Exhibit 4). Instead, we believe that the central bank will be forced to remain on hold this year. In our view, a lower peak rate means that the central bank will need to keep high rates for longer in order to contain the domestic inflation pressures.

We like flatteners between front-end and belly

This high-for-longer outlook in Colombia provides an attractive opportunity to enter flatteners. In particular, we like 1s5s IBR flatteners (current: -338), as there seems to be space for the curve to delay the cuts priced in the short term. We prefer to pay the 1y instead of the 2y tenor since 1y rates tend to be less sensitive to dovish shifts in central bank guidance than 2y rates.

Moreover, while we are gradually turning more constructive regarding the policy outlook in Colombia, we prefer to receive the 5y rather than the 10y tenor since it provides a cleaner monetary policy trade. The flattener also allows avoidance of exposure to the level of the curve, which could prove useful in a context of high uncertainty in US rates. Risks to the trade are a significant drop in core inflation or an aggressive dovish turn in BanRep that signals cuts in the very short term.

Exhibit 3: Core inflation has not yet peaked in Colombia
Core inflation (% yoy)



Source: BofA Global Research, Haver

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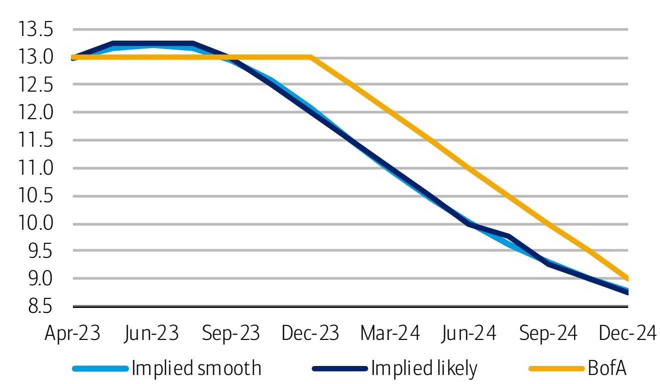
Exhibit 4: Market is pricing too many cuts in Colombia
Market-implied rate vs. BofA forecast (%)



Source: BofA Global Research, Bloomberg

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News and Views

Brazil: 2024-2026 inflation expectations stable, following the fiscal framework bill announcement

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According to the Brazilian Central Bank's (BCB) weekly survey (Focus), inflation expectations for 2023 continued to go up slightly, now at 6.04% (from 6.01% last week). Meanwhile, expectations for 2024, 2025 and 2026 remained stable at 4.18%, 4.00% and 4.00%, respectively. While inflation forecasts for 2025-2026 have been stable for weeks, expectations for 2024 had been going up, stabilizing after the fiscal rule bill submission in Congress. Median expectations for the Selic rate between 2023 and 2026 were the same as last week's, at 12.50%, 10.00%, 9.00% and 8.75%, respectively. GDP growth forecasts increased a touch for 2023, at 0.96% (from 0.90%), went up for 2024, reaching 1.41% (from 1.40%), and continued to go down for 2025, now at 1.70% (from 1.72%). Forecasts for 2026 remained stable at 1.80% (third consecutive week). Moreover, the exchange rate expectations appreciated slightly for 2023, 2024 and 2026, now at R$5.20/US$1 in YE23 (from R$5.24/US$1), R$5.25/US$1 in YE24 (from R$5.26/US$1) and R$5.32/US$1 in YE26 (from R$5.35/US$1). Exchange rate expectations for 2025 remained unchanged, at R$5.30/US$1.

- **To follow:** Eyes remain on the fiscal rule bill processing in Congress, with Roberto Campos Neto's testimony in the Senate, discussions about the inflation target system and news regarding the government's revenue boosting package also taking the stage. For now, consensus is just above our IPCA forecast of 6.00% for 2023-end, and remains higher than our expectation of 3.70% at 2024-end with long-term forecasts stable at 4%, in line with our scenario of an increase in 2024 mid-target to inflation to 4% (from 3%). Regarding interest rates, after a downward move in 2023 forecasts last week, consensus remained stable and more hawkish than our forecasts, with Selic rate expectations above our forecasts of 11.00% for 2023-end and 9.50% in 2024-end. GDP consensus estimates are above our forecast of 0.90% growth in 2023, but more pessimistic than our 2.40% growth expectation in 2024. The survey showed that market participants expect a slightly more depreciated currency at YE2023 and YE2024, as we recently revised our FX forecasts for R$5.10/US$1 and R$5.20/US$1, respectively.

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