Colombia | Economic Analysis

Banco de la Republica reduced its policy rate by 50 bp to 11.25%

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Banrep's Board maintained the pace of rate cuts of the last two meetings, with a 50bp reduction in June, accumulating a total of 200bp since it began its downward rate cycle in December 2023. The decision was split, with 4 members in favor of the 50bp reduction, two members in favor of a 75bp reduction, it is noteworthy that the Board was not attended by co-director Jaramillo.

- Banrep's Board statement highlights that total inflation remained stable but that core inflation (excluding food and regulated items) decreased from 6.4% to 6.1% in May. However, they highlighted that food inflation increased from 3.0% to 4.4%, noting that it was higher than expected. At the press conference the Governor highlighted that they expect inflation convergence to continue in the medium term but that there are some components among services (rents) that have shown high persistence. Regarding inflation expectations, the press release mentions that in the one-year term they are reduced by about 30bp and that those derived from the debt markets show a downward trend although still at levels above the inflation target.

  Among the inflation issues, the future increase of diesel was also highlighted. For the moment the increase is limited to a few consumers, but the future scenario of the adjustment is being evaluated. The Minister reiterated again that his estimate to close the diesel gap is approximately 1.4pp in inflation. However, he stressed again that the adjustment will surely be gradual and they are aiming to achieve this adjustment by the end of 2025. Another issue of relevance focused on food inflation. In this particular, they highlighted that the increase in food prices is considered to be transitory, however there are risks on this front. At the same time, they highlighted that there are risks focused on food due to the lags of the "El Niño" phenomenon and also as a result of the possible "La Niña" phenomenon.
- On the activity front, the press release highlighted that the first quarter result of 0.9% annual GDP growth was higher than the Staff estimate (0.3%). To this figure, it also added the comment that available figures for the second quarter suggest that the recovery in economic activity continued. In their responses at the press conference, both the Governor and the Minister emphasized that they already see signs of recovery in the economy. In the line of the labor market, and in reference to the recently published data, the Minister highlighted that the unemployment rate in Colombia is secularly high, close to 10%, the level at which it is currently, so they evaluate that the labor market is not in a state of crisis or recession.
- On the external front, it was noted that the risk premium and the exchange rate deteriorated in recent weeks, mainly due to external factors. On this front, they highlighted the uncertainty regarding the monetary policy tightening cycle in the United States. In response to more specific questions from analysts, they commented that there was a generalized deterioration in exchange rates in the region, which explains why this is not a singular event in Colombia. Regarding the volatility in the Colombian peso, it was pointed out that it is not very different from what has been observed in Mexico and Brazil in the last few weeks, so they do not consider it to be particularly harmful for the economy.

- Regarding the interest rate, both the Governor and the Minister emphasized that there is a consensus in the Board on the need to reduce the interest rate. For his part, the Minister emphasized that the real rate in this month was reduced by 50bp thanks to the stability in inflation and the 50bp reduction in the policy rate. The Minister detailed that some rates in the market have fallen more than the policy rate and that this new reduction should continue to support these rate reductions. For his part, the Governor highlighted that although the interest rate in Colombia is restrictive with the objective of bringing inflation to its target, there are other economies in the region that maintain higher real rates than those observed in Colombia. Among them, he highlighted Mexico and Brazil.
- Regarding market interest rates, they emphasized that the rate cut decisions of the different banks are based on their outlook for the Bank's future rate cut cycle. They incorporate a perspective of gradual but firm reduction of interest rates. Regarding the banks' results, the Governor commented that the increase in rates led to a higher funding cost and higher credit rates, which led to lower activity and higher delinquency rates, resulting in higher provisions that have affected the profitability of financial institutions, without affecting solvency indicators. He emphasized that banks showed their strength by overcoming this strong cycle of inflation and interest rates.

  At the press conference, it was emphasized that the weak performance of the banking sector in recent months is due to cyclical factors and has no relevant impact on solvency indicators. Additionally, they consider that the worst of the portfolio deterioration is already behind us and anticipate improvements in the performance of the loan portfolio. For his part, the Minister emphasized that the weak performance of the economy has multiple effects, among them he highlights that they have observed a lower than expected income tax collection, which increases the pressure to meet the fiscal goals and he comments that this justifies a faster reduction pace of interest rates.
- During the press conference, the Minister was asked about Moody's recent decision to ratify the rating and revise the outlook to negative from stable. Regarding this, the Minister emphasized that the news, more than the outlook revision, is that Moody's ratified Colombia's investment grade rating. The Governor, on the other hand, highlighted that the effects of the decision on the market have been marginal, which implies that it is not an event that generates alterations in the Board's evaluation of the situation.

Our view:

- The Board's decision to cut the rate by 50bp, with the balance of votes still split (4 to 2), is in line with the expectations of analysts, markets and BBVA Research in particular. The balance of activity and inflation remains around what was anticipated, with some slightly better than anticipated growth and inflation with some surprise in food, but not deviating much from expected levels. All of the above supports the status quo in the policy stance with 50bp cuts at each meeting.
- On this occasion, the discourse on the external context was maintained, particularly with regard to the less comfortable financial conditions and the deterioration in the exchange rate and risk premia. This is a factor that has been gaining more relevance in the Board's communication and we consider that it raises the relation of the rate reduction pace to the FED's rate policy cycle. With this, our scenario incorporates a rate cut in the US in September, which added to inflation resuming its downward path in August and an expected weakening in the labor market, should lead to a more accelerated rate cut in Colombia, of 75bp, starting in September and for some additional meetings thereafter...
- All in all, we continue to expect a gradual rate reduction in July and a rate that ends the year at 8.5%. On this expectation, there is a risk that rates will close higher, especially if the Federal Reserve does not initiate its tapering cycle in September.

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